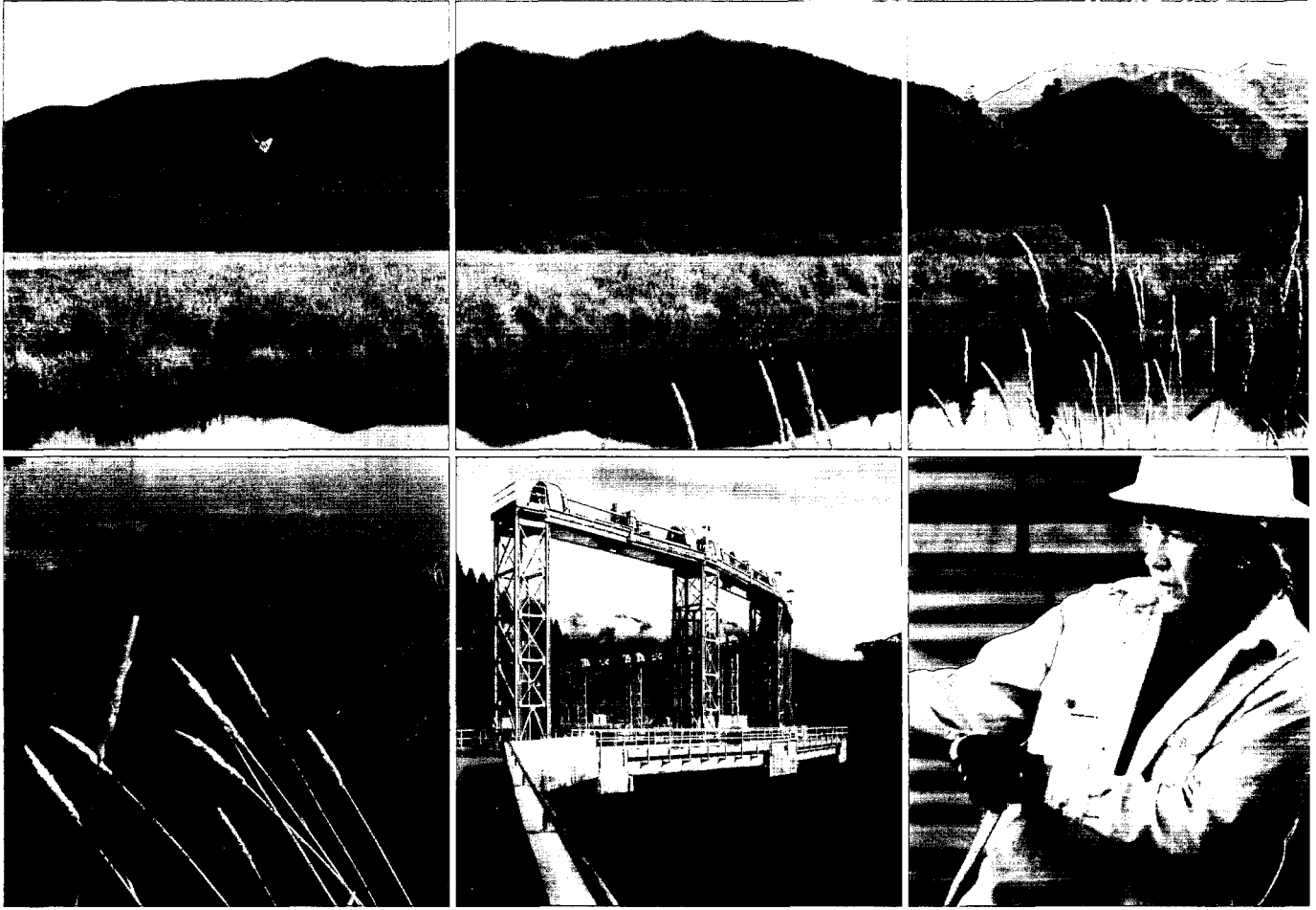


1-3701



05049065

04 Summary Annual Report



AVISTA
Corp.

THE NATURE OF ENERGY

PROCESSED

APR 04 2005

THOMSON
FINANCIAL



Energy, one of life's essentials, can perform wondrous things.

But behind that potential lies a most practical process
and the people who make it happen.

People who are solid. Clear-sighted. With deep roots
in the community.

People on the other end of the phone, or deep inside
the hydroelectric facility, or out in the trenches –
bringing energy to the manufacturing plant, the grade
school and the cabin by the lake.



Avista Businesses

With utility operations in five Western states, we are among the industry's leaders in performance, value and service. Avista's focus remains on our core utility business, along with other energy- and utility-related subsidiaries.

Avista Utilities provides energy to more than 330,000 electric and 305,000 natural gas customers, primarily in the Pacific Northwest.

Avista Energy applies energy marketing knowledge and experience to physical assets in Western regional markets.

Avista Advantage analyzes utility usage and provides cost management services for national, multi-site companies.

Table of Contents

3	Financial and Operating Highlights
4	Shareholder Letter
6	Avista in 2004
18	The Nature of Service
20	Board of Directors
21	Corporate and Business Unit Officers
22	Report of Independent Registered Public Accounting Firm and Management's Statement of Responsibility
23	Condensed Consolidated Statements of Income
24	Condensed Consolidated Balance Sheets
25	Condensed Consolidated Statements of Cash Flows
26	Financial Summary
28	Avista Utilities Service Territory
29	Corporate Information

Cover and inside front cover photos: A wetland that drains into Montana's Bull River, part of our bull trout recovery project (see page 17 for more information); the gate draw at the Cabinet Gorge Dam in Idaho; Kathy Kendall, equipment operator, at work in the Spokane equipment yard; Sunnyside Elementary fourth-graders Chanel Scudiero and Terry Yeh on the school's playground in Pullman, Washington.

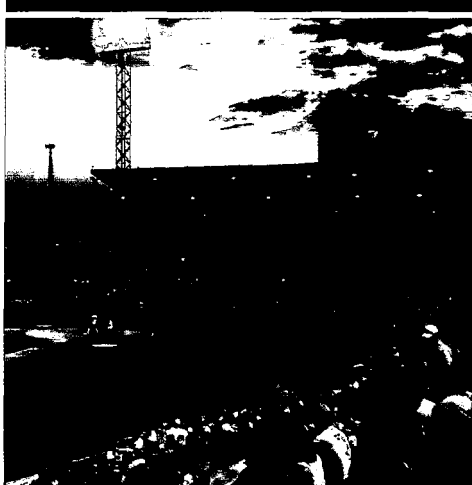
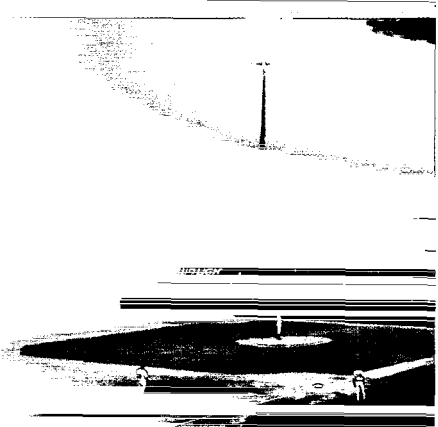


Our charge is clear: deliver value for our customers.

Every time.

All the time.

Avista. True to our nature.



*Just a few of Avista's customers:
V. Patrick Hughes, M.D. (top left),
a radiologist at Deer Park Hospital in
Washington; Sunnyside Elementary's
Darla Port (top) with fourth-graders
(from left) Vivek Jayaram, Ana
Acevedo-Barga and Leondra Crump in
Pullman, Washington; John L. Craig
(center left), owner of Craig's Cleaners
in La Grande, Oregon; Avista Stadium
(bottom), home of the Spokane Indians
baseball club.*

Financial and Operating Highlights
(Dollars in Thousands Except Statistics and Per Share Amounts or as Otherwise Indicated)

	2004	2003	2002
Financial Results			
Operating revenues	\$ 1,151,580	\$ 1,123,385	\$ 1,062,916
Operating expenses	<u>1,011,110</u>	<u>951,682</u>	<u>905,774</u>
Income from operations	<u>140,470</u>	<u>171,703</u>	<u>157,142</u>
Income from continuing operations	35,614	50,643	42,174
Loss from discontinued operations	<u>—</u>	<u>(4,949)</u>	<u>(6,719)</u>
Net income before cumulative effect of accounting change	35,614	45,694	35,455
Cumulative effect of accounting change	<u>(460)</u>	<u>(1,190)</u>	<u>(4,148)</u>
Net income	35,154	44,504	31,307
Deduct – preferred stock dividend requirements ⁽¹⁾	<u>—</u>	<u>1,125</u>	<u>2,402</u>
Income available for common stock	<u>\$ 35,154</u>	<u>\$ 43,379</u>	<u>\$ 28,905</u>
Earnings per common share from continuing operations, diluted	\$ 0.73	\$ 1.02	\$ 0.83
Loss per common share from discontinued operations, diluted	<u>—</u>	<u>(0.10)</u>	<u>(0.14)</u>
Earnings per common share before cumulative effect of accounting change, diluted	0.73	0.92	0.69
Loss per common share from cumulative effect of accounting change, diluted	<u>(0.01)</u>	<u>(0.03)</u>	<u>(0.09)</u>
Earnings per common share, diluted	<u>\$ 0.72</u>	<u>\$ 0.89</u>	<u>\$ 0.60</u>
Earnings per common share, basic	\$ 0.73	\$ 0.90	\$ 0.60
Dividends paid per common share	0.515	0.490	0.480
Book value per common share	\$ 15.54	\$ 15.54	\$ 14.84
Average common shares outstanding	48,400	48,232	47,823
Actual common shares outstanding	48,472	48,344	48,044
Return on average common equity	4.7%	5.9%	4.0%
Common stock closing price	\$ 17.67	\$ 18.12	\$ 11.56
Operating Results			
Avista Utilities			
Retail electric revenues	\$ 506,428	\$ 489,168	\$ 463,667
Retail kWh sales (in millions)	8,363	8,027	7,584
Retail electric customers at year-end	331,014	325,554	320,210
Wholesale electric revenues	\$ 62,399	\$ 73,463	\$ 64,082
Wholesale kWh sales (in millions)	1,472	2,075	2,216
Total natural gas revenues	\$ 320,493	\$ 277,289	\$ 309,823
Total therms delivered (in thousands)	495,584	490,474	516,491
Retail natural gas customers at year-end	304,850	298,296	290,188
Income from continuing operations	\$ 32,467	\$ 36,241	\$ 36,382
Energy Marketing and Resource Management			
Gross margin (operating revenues less resource costs)	\$ 38,842	\$ 60,189	\$ 54,207
Income from continuing operations	\$ 9,733	\$ 20,672	\$ 22,425
kWh sales (in millions)	32,629	41,579	40,426
Natural gas sales (thousands of dekatherms)	219,719	228,397	225,983
Avista Advantage			
Revenues	\$ 23,444	\$ 19,839	\$ 16,911
Income (loss) from continuing operations	577	(1,334)	(4,253)
Other			
Revenues	\$ 17,127	\$ 13,581	\$ 14,645
Loss from continuing operations	(7,163)	(4,936)	(12,380)
Financial Condition			
Total assets	\$ 3,703,823	\$ 3,640,075	\$ 3,799,543
Long-term debt	901,556	925,012	902,635
Long-term debt to affiliated trusts ⁽²⁾	113,403	113,403	—
Preferred trust securities ⁽²⁾	—	—	100,000
Preferred stock (subject to mandatory redemption) ⁽¹⁾	28,000	29,750	33,250
Common equity	753,205	751,252	712,791

⁽¹⁾ Pursuant to changes in accounting principles in 2003, preferred stock was reclassified to liabilities and preferred stock dividend requirements were reclassified to interest expense effective July 1, 2003.

⁽²⁾ Pursuant to changes in accounting principles in 2003, Avista Corporation no longer consolidates the affiliated trusts that have issued preferred trust securities.

FELLOW SHAREHOLDERS

“Regardless of business challenges or leadership style, Avista remains fundamentally the same. That’s been true for well over a century. Our people inherently understand the company’s obligation of stewardship, and so it endures.” Gary G. Ely

Essential.

That’s the nature of our business, a realization that weighs heavily on my mind. People depend on the service we provide – every day, in every part of their lives. When I think about how hard our crews work to deliver reliable energy to our customers, it profoundly touches me.

This stewardship requires steadiness, sure planning and a stable infrastructure. Avista strives to demonstrate those attributes year in and year out, and 2004 was no exception.

We continued to invest in our assets – generation, transmission and distribution. Together, these systems and our employees who run them ensure our customers have dependable service.

Our seriousness about dependability extends to you, our shareholders, too. We view Avista as a solid long-term investment. Bearing that perspective in mind, we have to be prepared for years in which we struggle. Last year was such a year.

The Idaho Public Utilities Commission issued a disappointing order in our general electric and natural gas rate case in October. Although the commission approved a base rate increase of 16.9 and 6.4 percent, respectively, it also required write-offs totaling \$14.4 million. We had deferred the cost of certain natural gas contracts we entered into to fuel our thermal generating facilities, but the commission disallowed recovery of those and other capitalized utility plant costs we believe were prudently incurred.

That decision, along with higher-than-normal natural gas prices, lower-than-normal hydro stream flow, and thus lower cash flow than we expected, had a dampening effect on 2004’s financial results. We finished the year with net income available for common stock of \$35.2 million and earnings of \$0.72 per diluted share.

While they’re not as strong as we might like them to be, those numbers do not diminish our confidence in Avista or future prospects.

We took several measures in 2004 to reinforce our long-term strategy of building and maintaining robust infrastructure in the Pacific Northwest.

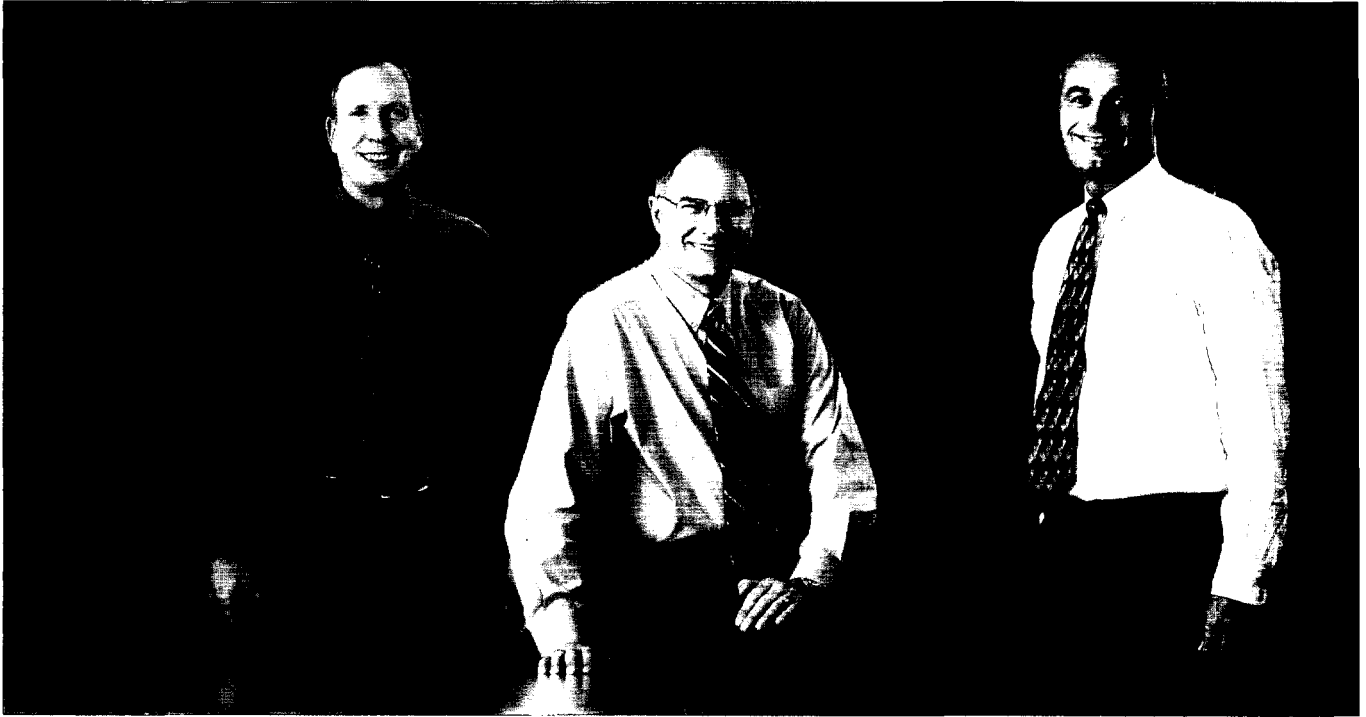
Our crews completed a \$15 million transmission line upgrade in our service territory and laid the groundwork for another, slated to begin in 2005. Both projects are part of an investment of more than \$100 million in our transmission system, an undertaking we deem particularly vital.

We also modernized two substations, wrapped up a \$7 million improvement to Cabinet Gorge hydroelectric project unit #2 – increasing generation capacity for that unit by about 30 percent – and we reached an agreement to purchase the other half of the Coyote Springs 2 natural gas-fired generating plant from Mirant.

Our regional focus led us to reconsider the compatibility of our California properties with Avista’s core business. Consequently, we agreed to sell our natural gas distribution properties in South Lake Tahoe to Southwest Gas Corporation for \$15 million.

By concentrating on the region we know best, we provide Avista with well-defined criteria for growth. That approach has also proven effective at Avista Energy, our energy marketing and resource management subsidiary. Confining Avista Energy’s operations to the western United States and western Canada capitalizes on our strengths – and prolonged the unit’s continuous profitability to 18 quarters. Although we had higher expectations for Avista Energy’s 2004 performance, it continues to be a sound business model.

Believing a prosperous region will advance our objectives, we’ve maintained Avista’s longstanding involvement in our communities, promoting and



Malyn M. Malquist
Senior Vice President, Chief Financial
Officer and Treasurer, Avista Corp.

Gary G. Ely
Chairman, President and Chief Executive
Officer, Avista Corp.

Scott L. Morris
Senior Vice President, Avista Corp.
President, Avista Utilities

contributing to a number of economic development efforts. You can read more about those on page 9.

And to further ensure the ongoing health of our company, we're deliberately nurturing leaders who will uphold Avista's legacy of service to customer, community and shareholder well into the future.

Like many companies across the country, Avista faces an aging workforce. We've tackled that issue head-on, systematically spreading our veteran workers' expertise to their colleagues. Our stability comes, and will always come, from our people, people who understand and deeply value what Avista represents.

You'll meet some of them in the pages that follow. Every year, I have an opportunity to speak directly to you in this letter, but we want you to get to know some of the other fine employees running our company, as well. Scott Morris, the president of Avista Utilities, will tell you more about our growth strategy. You'll get additional information about our progress toward renewed financial strength from CFO Malyn Malquist, and Patty Shea, manager, energy emergency services, will address Avista's

commitment to reliable service. You'll also hear from Anne Marie Axworthy, Dennis Vermillion and Dana Anderson.

These and other leaders are preparing themselves and Avista for tomorrow's challenges, which include: regaining our investment-grade credit rating, improving Avista's financial position, continuing recent dividend trends, and fully realizing Avista Advantage's potential to positively affect earnings with little risk to the corporation.

I have no doubt that Avista's people are up to the task. They impress me every day with the dedication and enthusiasm they bring to their work. And I know they join with me in thanking you for your confidence in our company.

Gary G. Ely
Chairman, President and Chief Executive Officer
March 11, 2005

THE NATURE OF INITIATIVE

“Reliability doesn’t just happen. It takes hard work every day, at projects as complicated as upgrading an entire transmission line or as simple as resetting a single pole.” Gary G. Ely

If we do our job right, nobody notices. The lights come on, the stove fires up, the heat flows out.

But a lot of work and thought go into something that seems so effortless. It’s an enterprise Avista understands – and does – well.

Reliability like Avista’s, as well as our long-term competitiveness, depends on adequate power generation. So we’re particularly pleased that the Coyote Springs 2 natural gas-fired generating facility in Boardman, Oregon, has been fully operational since September. After a number of manufacturer-related technical problems, the repaired transformer is performing to expectations. And to ensure future reliability, we ordered a back-up transformer from another vendor; it was delivered in November.

We also purchased Mirant’s 50 percent ownership in the facility for \$62.5 million – which we intend to include in our rate base – adding Coyote Springs 2’s entire 280-megawatt output to our resource base. (One megawatt provides enough energy for about 650 homes.)

The move goes a good way toward securing the resources we’ll need in coming years. Further, 2004’s

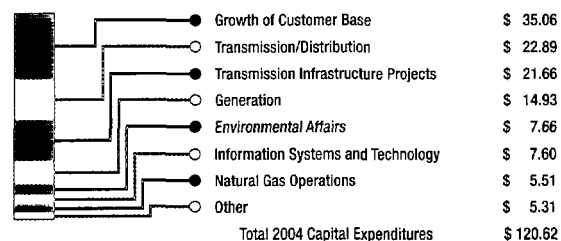
upgrades to the Cabinet Gorge hydroelectric project on the Clark Fork River in Idaho and Montana raised its capacity from 246 to 262 megawatts, and we’re also considering increasing our wind and coal power supply.

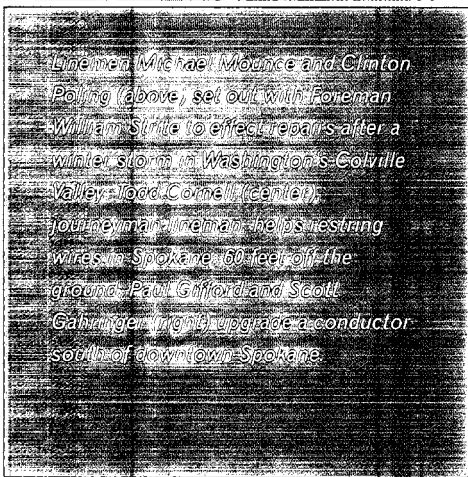
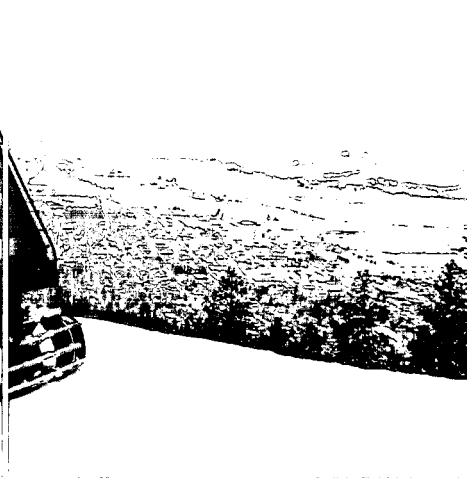
Naturally, there’s more to dependable service than generation, and we’re in the midst of a five-year transmission system upgrade of over \$100 million. While we finished converting our 25-mile Beacon-Rathdrum route to a double-circuit line – effectively quadrupling capacity – we organized several public meetings to gather input before we launched into our next assignment, the Boulder substation.

The Boulder project adds 500 megawatts of capacity to our transmission delivery system, serving Spokane Valley and Liberty Lake, Washington, two growing communities in our territory.

Such large-scale projects get plenty of attention, of course, but never to the exclusion of the less-glamorous but essential maintenance Avista’s teams perform so unfailingly. Our crews are out in the field every day, resetting poles, restringing wires, laying pipe, responding to trouble calls and taking care of our customers. They’re the heart of Avista.

Our capital budget expenditures for 2004 (shown in millions) substantiate Avista’s emphasis on maintaining reliable service for our customers – today and in the years ahead.





Linemen Michael Mounce and Clinton Poling (above, set out with Foreman William Strite to effect repairs after a winter storm in Washington's Colville Valley; Todd Cornell (center), journeyman lineman, helps restring wires in Spokane, 60 feet off the ground; Paul Gifford and Scott Gahringer (right) upgrade a conductor south of downtown Spokane.



"When customers experience an outage, their world almost stops. We want to get our customers back in service as quickly and efficiently and safely as possible. That's the driver for everything. It's customer service. We really want to be a cost-competitive, high-reliability energy provider for our customers."

Patty Shea

Patty Shea
Manager, Energy Emergency Services, Avista Utilities



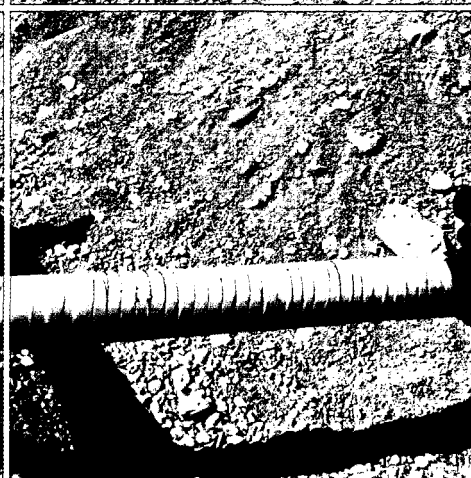
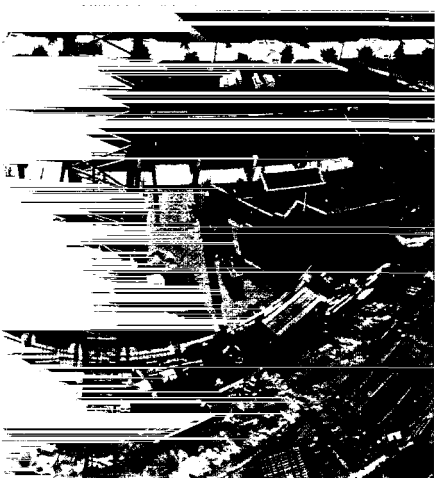
"We have a unique ability to make a difference. You look out your window, and every home and business is our customer. Obviously, we have a vested interest in helping the region grow, and our growth strategy is this: If we can help the community be successful, ultimately, our shareholders and customers win."

Scott Morris

Scott L. Morris

Senior Vice President, Avista Corp. and President, Avista Utilities

...to support community projects
...WASU Spokane Academic
...center (shown) under construction in
...Spokane's downtown University
...and the high-pressure gas main
...supply custom cabinet
...timberwood industries new
...square-foot building in
...Lake Washington.



THE NATURE OF PROGRESS

"Growth at any cost doesn't interest us. But smart growth is another story. It commands our attention, warrants our best resources and guides our every decision." Gary G. Ely

This is the hard truth of it: For Avista to prosper and grow, the communities where we do business must thrive.

Fortunately, that tracks well with our core belief in collaboration, and we've found smart, strategic ways to work with myriad organizations to promote the well-being of our communities – and our company, as well.

The regional Virtual Possibilities Network (VPnet) is a case in point.

This 200-mile optical fiber system links two of our region's largest industries – healthcare and education – to each other and the world beyond. The network's 15 founding members include Spokane's public schools; regional colleges, universities and research institutions; healthcare facilities; and Pacific Northwest National Laboratory. An Avista subsidiary donated the fiber backbone that makes VPnet – and the research and innovation it will spur – possible. Within five years, we estimate the economic benefit to our region could total \$60 million to \$85 million per year.

Another project we're supporting, Spokane's University District, corresponds nicely with VPnet's goals.

Again, we've joined with other community organizations to bring healthcare and education together, this time physically.

We've lent leadership to this project, intended to draw the region's higher education and medical sectors to the east end of downtown Spokane, where we believe their

proximity will stimulate research and new business development. The district's economic impact could reach \$200 million to \$300 million annually.

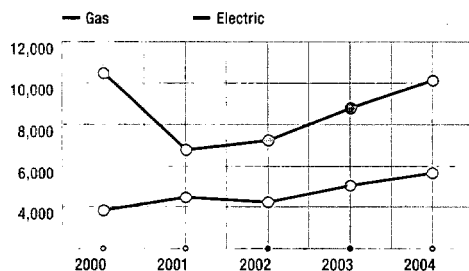
Confident in these two initiatives' potential to attract talent to our area, we're also participating in a regional recruitment effort that pools the collective resources of a number of businesses and community leaders.

As all these endeavors yield growth, they'll also bring the need for adequate infrastructure to support it. We'll be ready.

Our engineers are reviewing the final draft of the University District design and making preparations to serve the project. It's the sort of thing they do all the time, closely coordinating Avista's expansion with the community's.

In Liberty Lake, Washington, for instance, we're upgrading our system in tandem with a new manufacturer's construction there. Nearby in Coeur d'Alene, Idaho, we're installing gas pipe in a high-end, 100-home development in anticipation of a gas main extension within the next five years. We've even launched a 40-module training program for our field personnel to help them make decisions on the spot in the best interest of our customers.

Such measures reflect our inclination toward that which is mutually beneficial. Seeking the good of the community and acting as a collaborative business partner really serves us all.



As the region's economy expands, demand for new electric and natural gas hook-ups does, too.

THE NATURE OF CARING

“What we do affects people, and we always take that into account because our success depends as much on the goodwill we create as on any other factor.” Gary G. Ely

Avista believes in doing the right thing – both because it's the right thing and because it's good for business.

We are linked to our communities in ways many industries are not. That's part of why helping people is important to Avista.

Our Customer Assistance, Referral and Evaluation Service (CARES) program is one way we help. Since the mid-1980s, our CARES representatives have been working with customers in difficult financial circumstances so they can better make ends meet. By educating people about aid programs they qualify for and advocating on their behalf, Avista retains customers, builds trust with the community and collects what would otherwise be lost. And CARES not only does all that, it pays for itself at the same time.

Similarly, the Project Share program turns short-term customer support into long-term company good. With one-time, emergency funds, Project Share helps people having trouble paying their winter energy bills. Our customers donate the funds. We accept those donations and, along with our corporate contribution, give the money to our region's community action agencies for distribution. This year, we gave \$200,000, our customers donated more than \$325,000, and our employees contributed by buying “Share the Warmth” coffee and gift items.

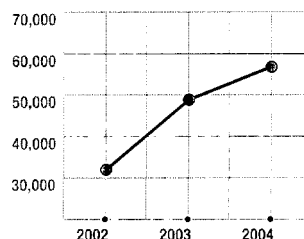
Donating money is just the beginning of what our

employees do. Every year, we set a volunteer goal for our service territory; 2004's was 50,000 hours, which we exceeded by nearly 6,000 hours. Employees did everything from hanging Christmas lights to running school supply drives to coaching sports teams to teaching Junior Achievement classes in business management – mostly on their own time. Our employees served thousands of Meals on Wheels lunches, worked with Spokane elementary school students improving reading skills through the Lunch Buddies program, helped RSVP (Retired Senior Volunteer Program) knit and distribute 5,000 items to needy people, and donated 2,250 pounds of fresh produce grown in our Green Thumbs community garden project.

It doesn't stop at food and clothing either. This year, Avista deployed 164 automated external defibrillators (AED) in company buildings and vehicles – the nation's largest, single implementation for a utility. With these units, our trained personnel can perform life-saving measures for our employees and the public. We see the AEDs as a constructive investment in our most important asset: people.

This commitment to people and sound business practices is inherent in Avista's approach. By doing our best to maintain good relations with the community, Native American tribes, regulators and our employees, we're able to help others while ensuring our success.

Avista employees volunteer thousands of hours to foster the success of more than 500 nonprofit organizations – and the communities we all serve.





"The scope of our business is so wide. We serve the entire community – and we need to do that in a mutually beneficial way. We have to understand and respect what others need to accomplish, and we need to be forthright about what's important to us. It's about mutual respect."

Anne Marie Axworthy

Anne Marie Axworthy
Director, Community Development, Avista Utilities



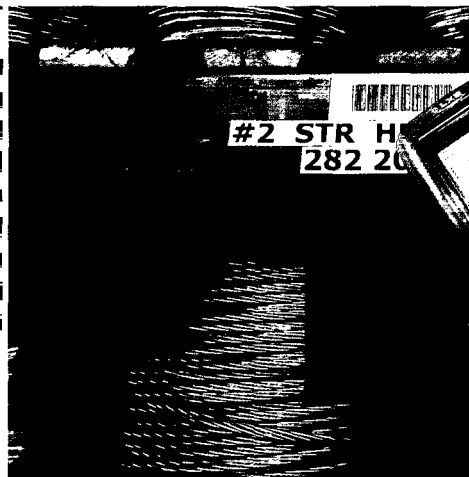
Avista contributed funds toward this natural gas fire pit in Lewiston, Idaho's Locomotive Park (above), site of the Winter Spirit Festival. Rose Byers (right, in photo left) is one of many of our communities' vulnerable citizens helped by CARES representatives like Cheryl Scheideman.



"We chose to strike a balance between the needs of our customers and our shareholders, so we're not getting healthy overnight. We're going to do things in a measured, steady fashion. We're going to set goals, and we're going to go out and achieve those goals. And we will get there."

Malyn K. Malquist
Senior Vice President, Chief Financial Officer and Treasurer, Avista Corp.

...its new wireless inventory
...taking increases accuracy
...Diane Thoren, assistant
...Christy Burmeister-Smith,
...the controller, and
...director of internal audit
...review data captured by
...financial and supply
...software.



THE NATURE OF RESOLVE

"Earning trust isn't a part-time job. When we told you we'd restore Avista to financial strength, we knew we had the skills and fortitude to see it through." Gary G. Ely

Here's where Avista's steadiness really serves us well.

Like many energy companies, we suffered some financial blows a few years ago when energy prices spiked dramatically. Since that time, we've single-mindedly marched our way back toward financial health. To us, that means less risk, less volatility, stronger cash flow, more stable earnings and better overall performance.

Getting there is a long process, of course, but we can point to several important milestones along the way. We raised common stock dividends three times in an 18-month period, and we've replaced Avista's aging financial and supply chain software with a markedly more effective system.

That particular task was more than a year in the works. We proceeded with characteristic care, and we've been rewarded by the outcome. The project came in right on time and on budget, and the new system gives us more meaningful, more timely information than we've ever had before, allowing us to accurately pinpoint costs for every part of our business.

But there's still progress to be made.

We mean to earn the rates of return authorized by the commissions overseeing our regulated operations, and we'll file rate cases in support of that goal, always bearing our customers' needs in mind as well.

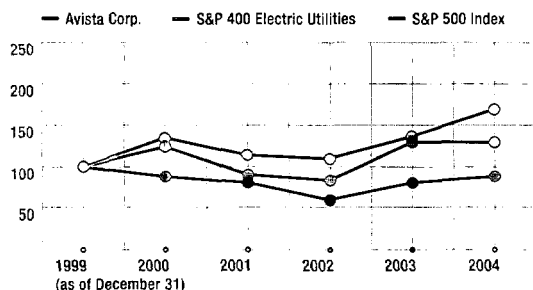
Earning the allowed return will help us generate cash

flow sufficient to fund our capital budget and minimize our need to tap capital markets to fund required debt maturities. We also recently entered into a \$350 million five-year committed line of credit – replacing a 364-day agreement – which offers us further financial flexibility.

We're also looking for opportunities to take greater advantage of the low-interest environment to reduce high-cost debt. In 2004, we issued \$90 million in first mortgage bonds at 5.45 percent, and the proceeds repaid short-term debt. Our eventual aim is better balance in our debt-to-equity ratio, which currently stands at 60-40.

Ongoing efforts to improve Avista's credit rating have yielded favorable results, but we still have a ways to go there, too. We're getting closer to attaining investment-grade status, and though it may be a year or more before we reach our objective, we're determined to regain a position appropriate for a company as enduring as Avista.

Ultimately, a strengthened financial outlook will advance our infrastructure goals, freeing funds for projects that maintain the level of reliability, service and stewardship our customers rightly expect of us. In 2005, our \$130 million capital budget will support projects such as transmission upgrades and hydroelectric plant relicensing and upgrades, as well as customer growth. In weighing these priorities, we always strive to act as good stewards of all our resources, financial and physical alike.



At Avista, we're aiming for long-term gain. A \$100 investment in Avista on December 31, 1999, compares favorably relative to the same investment in Standard & Poor's 500 Index and the Standard & Poor's 400 Electric Utilities Index (source: S&P, January 10, 2005).

THE NATURE OF CLARITY

“‘Play to your strengths’ is good advice, and we only pursue opportunities consistent with what we do best.” Gary G. Ely

We can't be experts at everything. We know that. Consequently, Avista chooses carefully and focuses intently.

That's why we opted to sell our California properties. Our South Lake Tahoe natural gas distribution system, which we acquired in 1991 along with properties in Oregon, is isolated from the rest of our territory. The pending sale to Southwest Gas for \$15 million eliminates the challenges of serving a remote pocket of customers in a jurisdiction outside our core service area. And it allows us to concentrate our attention on the Pacific Northwest region we know so well.

An example: The Pacific Northwest's abundant hydropower offers renewable and relatively low-cost power, but effectively operating and maintaining hydro generation facilities takes a certain kind of expertise. Avista Utilities' employees have that. We understand stream flows, snow pack, precipitation levels and spill requirements – and how those variables affect supply – as well as anyone in the industry.

The team at Avista Energy possesses that same aptitude, which plainly accounts for our energy marketing and resource management unit's consistent performance. Because Avista Energy operates on an asset-based model, we help our customers get the most out of their generation facilities through portfolio planning, smart fuel purchasing strategies, long-term sales and even trading.

The latter activity sometimes evokes concern among

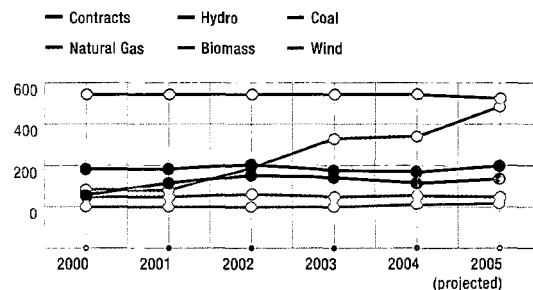
our investors, and justly so. Energy trading has raised eyebrows all across the country. But we think Avista Energy's reliance on hard assets and sound risk management practices makes it different. We're actually improving our customers' ability to efficiently manage their facilities, and for that reason, we consider Avista Energy a sensible business consistent with our values. And it exemplifies a logical extension of our fundamental energy expertise.

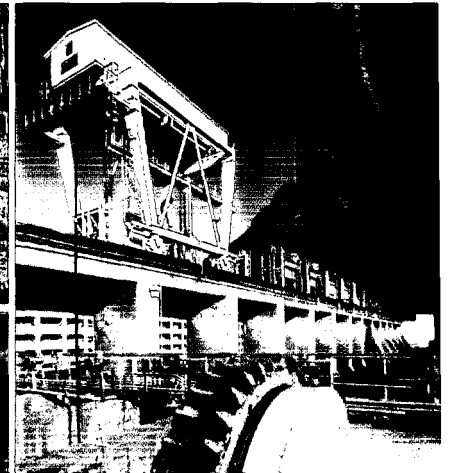
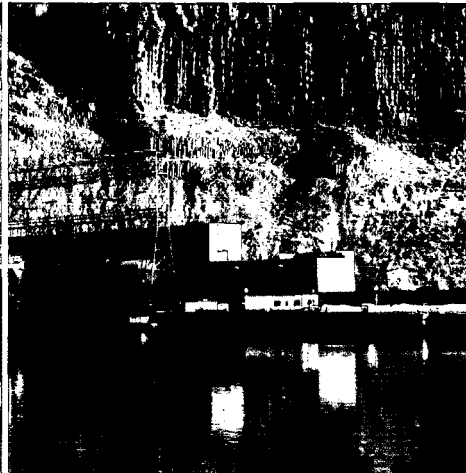
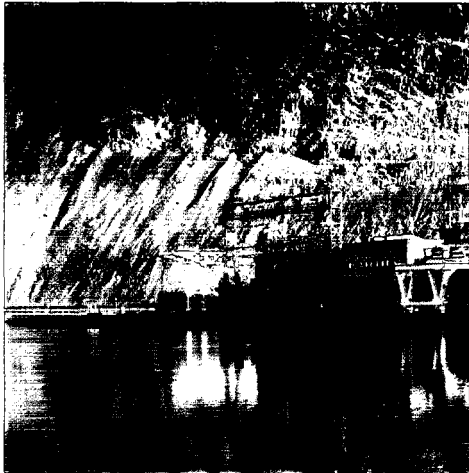
Avista Advantage does, too. This subsidiary, which streamlines utility billing and related business processes for multi-site organizations, grew out of our command of how utilities function. Today, it leads a \$300 billion industry that hardly existed before we entered the marketplace.

Last year we added more than 40 customers, representing 25,000 sites, and retained 96 percent of our existing customers, for a total of 150,000 sites. We qualified as a Service and Product Provider for the U.S. Environmental Protection Agency's ENERGY STAR® program, and by the end of 2004, we'd handled more than one-third of all buildings EPA rated last year – nearly four times as many as the next highest provider. And, as we turned the reins over to new president Stu Stiles, we achieved our second consecutive positive earnings quarter.

That's what can happen when you pay close attention to what you do well.

Because we understand our region and the trends that shape its economy, Avista knows how to formulate the right mix of contracts and hydro, coal, natural gas, biomass and wind power to achieve sufficient average megawatts for our customers' load requirements.



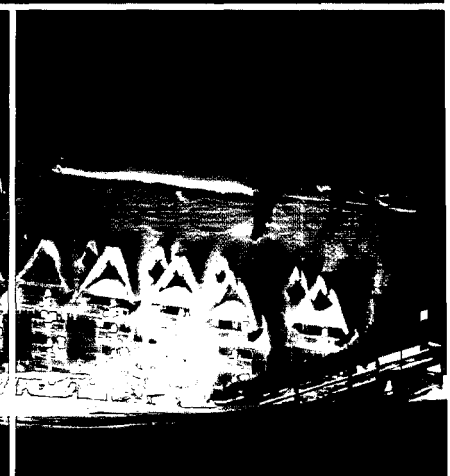


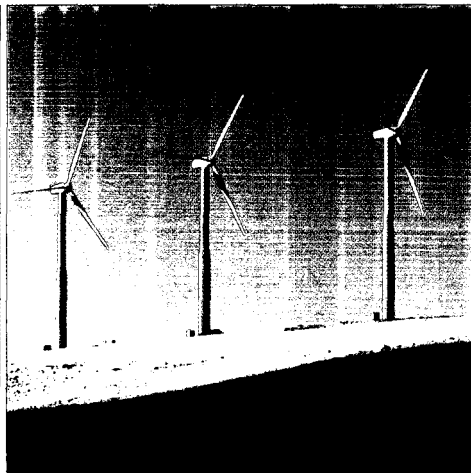
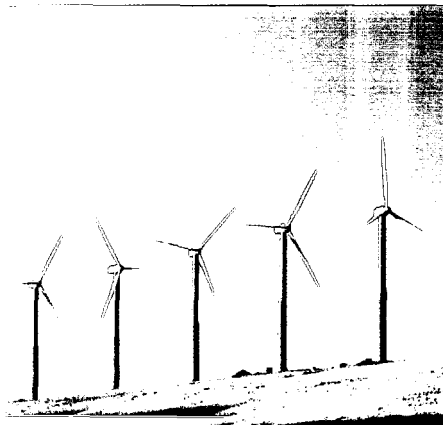
"We focus our energies in areas where we believe we have a core competency. This is our backyard, the Northwest. We grew up in the industry here, and we have a proven track record over the years. Focusing on that is the right move."

Dennis Vermillion

Dennis Vermillion
President and Chief Operating Officer, Avista Energy

Through Avista Energy's agreement with Chelan County Public Utility District, we help them manage Rock Island Dam (top), near Wenatchee, Washington, as efficiently as possible. Operating in the Pacific Northwest brings its own challenges and joys - like the Schweitzer Ski Resort (right) near Sandpoint, Idaho.



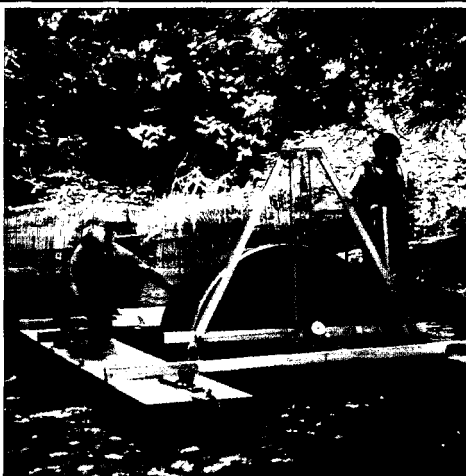
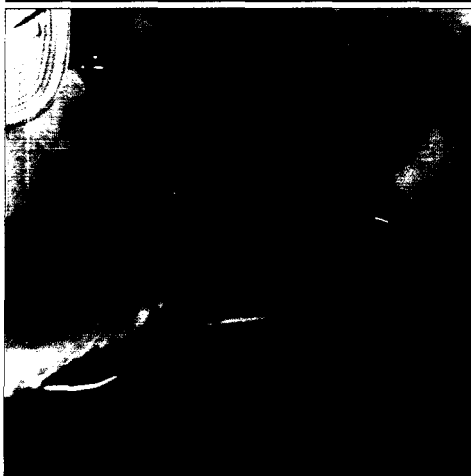


FPL Energy's Stateline Wind Energy Center (above), near Walla Walla, Washington, contributes to our resource portfolio. Avista's bull trout recovery work (below) has been underway since 1999; we contract with agencies like Idaho Fish and Game and Montana Fish, Wildlife & Parks to provide full-time fish biologists.

"Leadership is highly valued at Avista – and it's collaborative. Ideas are encouraged and welcomed. We really seek to involve as many different individuals as possible when it comes to making decisions to ensure the best possible outcome. Leadership is everyone's job."

Dana Anderson

Dana Anderson
Director, Customer Solutions, Avista Utilities



THE NATURE OF LEADERSHIP

"Effective leadership requires consent. That's why we place such importance on cultivating relationships of trust with our customers, communities, employees and shareholders." Gary G. Ely

We don't look at leadership as the province of a single person or group of people. It's central to Avista's character, and it extends into every area of our business.

Wind power is a good example.

Always open to new resources and technologies, we've been evaluating wind power for the last several years. In April, we reached an agreement with PPM Energy to purchase up to 35 megawatts of energy capability and renewable energy credits from FPL Energy's Stateline Wind Energy Center near Walla Walla, Washington, the largest single wind generating facility in the United States.

We like the arrangement for several reasons: it's a regional undertaking, it secures supply for our customers from a source they've told us they like, and it's an environmentally responsible thing to do.

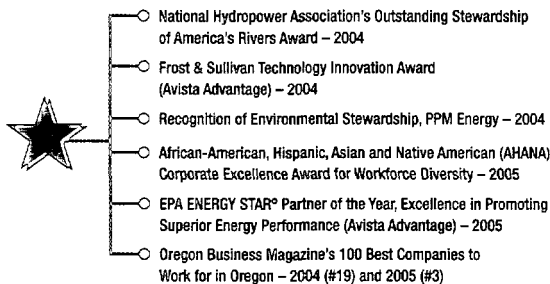
Avista Utilities put new technology to work this year, too, with a similarly positive effect. By finishing the automation of all 75,000 natural gas meters in our Oregon service territory, we reduced the cost to read each from \$4.88 per year to less than \$1.50. We plan to do the same in Idaho next.

But the new system does more than lower costs. It also reduces the more than 750,000 miles per year we drive to read meters, an environmental benefit we appreciate.

Stewardship is something we take very seriously, as two recent awards further demonstrate. We were one of nine recipients of the 2004 Outstanding Stewardship of America's Rivers honor from the National Hydropower Association for our work on Idaho and Montana's Clark Fork River. This is the sixth straight year we've been recognized. NHA also praised our recreation resource management plan for the Clark Fork, site of our two largest hydroelectric projects. And Avista was the first entity in the nation to partner with the U.S. Fish and Wildlife Service to test a new genetic procedure for bull trout recovery.

We're mindful of our stewardship responsibilities internally, as well. Our Aspiring Leader Program, launched in 2003, identifies employees with leadership potential who are not currently in leadership roles and increases their readiness for the future. For a year, program participants spend 15 percent of their time performing coursework and rotating among various departments across the company.

Through the Aspiring Leader Program and other development methods, we nurture talented people who will carry the values and guiding principles of today's Avista and lead the company into the years to come.



When you're a leader, others notice.

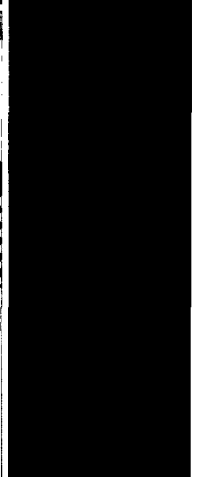
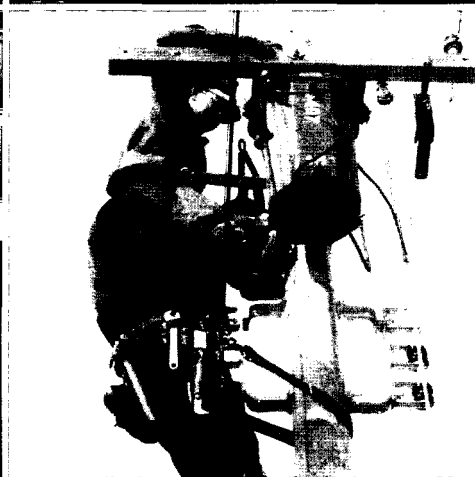
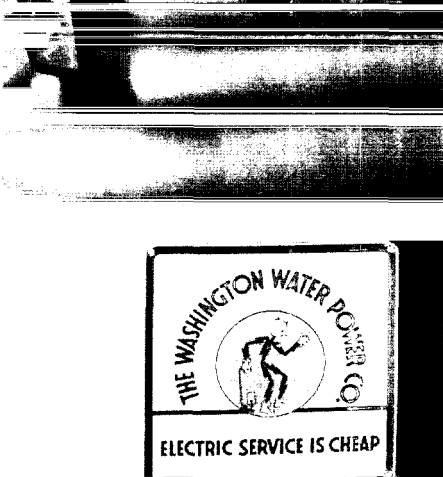
THE NATURE




We are in business to serve our customers.

What's important to them is important to us – which is why Avista is so dedicated to the communities we share.

And we always have been.



A  Avista's people – like the work crew at Long Lake Dam, 1912 (A); Don Nelson, 1955 (B); Ken Curren, Pete Hamilton, Dale Mills and Cy Secor, 1961 (C); Lou Rader and Willard Briggs, 1950 (D); and Lorraine Monet, ca. 1974 (E) – have been taking care of our customers for well over a century.

OF SERVICE



Today's customers – The Spokane Veterans Memorial Arena (A); Nicola Morgan at the Chewelah, Washington, Public Library (B); barbecue fans (and Avista employees) Dave and Nancy Holmes in Spokane (C); and The Davenport Hotel Floral Shop's Celeste Noffsinger in Spokane (D) – count on us to bring that same level of service into their lives.

BOARD OF DIRECTORS

Erik J. Anderson – President, Westriver Capital, Kirkland, Washington. Director since 2000.

Kristianne Blake – Principal, Kristianne Gates Blake, P.S., Spokane, Washington. Director since 2000.

David A. Clack – Managing Director, Meridian Capital, Spokane, Washington. Director since 1988.

Roy Lewis Eiguren – Senior Partner, Givens Pursley, LLP, Boise, Idaho. Director since 2002.

Gary G. Ely – Chairman of the Board, President and Chief Executive Officer, Avista Corp., Spokane, Washington. Director since 2001.

Jack W. Gustavel – Chairman and CEO, Idaho Independent Bank, Coeur d'Alene, Idaho. Director since 2003.

John F. Kelly – President and CEO, John F. Kelly & Associates, Paradise Valley, Arizona. Director since 1997.

Jessie J. Knight, Jr. – President and CEO, San Diego Regional Chamber of Commerce. Director since 1999.

Michael L. Noël – President, Noël Consulting Company, Prescott, Arizona. Director since 2004.

Lura J. Powell, Ph.D. – President and CEO, Advanced Imaging Technologies, Richland, Washington. Director since 2003.

R. John Taylor – Chairman and Chief Executive Officer, AIA Services Corporation, Lewiston, Idaho. Director since 1985.



Audit Committee

We owe those who entrust us with their money the highest standard of probity. By overseeing the integrity of our financial statements and our internal controls for finance, accounting, legal compliance and ethics, the Audit Committee helps us meet that standard.

Jessie J. Knight, Jr.
Kristianne Blake, Chairperson
Michael L. Noël
David A. Clack



Corporate Governance/Nominating Committee

A well-considered structure for the board of directors translates into effective committee oversight, a balanced board membership, and policies and procedures that reflect Avista's values. The Corporate Governance/Nominating Committee advises the board in such matters.

Lura J. Powell
R. John Taylor, Chairperson
Kristianne Blake
Jack W. Gustavel



Environmental, Safety & Security Committee

A company with operations as complex and geographically dispersed as Avista's has a duty to protect our employees' safety and security and the environmental resources under our care. The Environmental, Safety & Security Committee provides management with policy guidance on these issues.

David A. Clack, Chairperson
Lura J. Powell
Roy Lewis Eiguren



Compensation & Organization Committee

Roy Lewis Eiguren
John F. Kelly, Chairperson
R. John Taylor



Executive Committee

R. John Taylor
David A. Clack
Kristianne Blake
Gary G. Ely, Chairperson



Finance Committee

Jack W. Gustavel
Michael L. Noël
Erik J. Anderson, Chairperson

CORPORATE AND BUSINESS UNIT OFFICERS



Gary G. Ely
Chairman of the Board,
President and Chief Executive
Officer, Avista Corp.



Malyn K. Malquist
Senior Vice President,
Chief Financial Officer and
Treasurer, Avista Corp.



Scott L. Morris
Senior Vice President,
Avista Corp.
President, Avista Utilities



Christy Burmeister-Smith
Vice President and
Controller, Avista Corp.



Karen S. Feltes
Vice President and Corporate
Secretary, Avista Corp., with
responsibility for Human
Resources



Don Kopczynski
Vice President, Avista Corp.,
with responsibility for
Transmission and Distribution
Operations



David J. Meyer
Vice President and Chief
Counsel for Regulatory and
Governmental Affairs,
Avista Corp.



Kelly Morwood
Vice President, Avista Corp.,
with responsibility for State
and Federal Regulation



Ronald R. Peterson
Vice President, Avista Corp.,
with responsibility for Energy
Resources



Roger D. Woodworth
Vice President, Avista Corp.,
with responsibility for Business
Development



Stu Stiles
President and Chief Executive
Officer, Avista Advantage



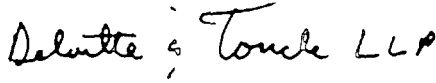
Dennis Vermillion
President and
Chief Operating Officer,
Avista Energy

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of
Avista Corporation and subsidiaries
Spokane, Washington

We have audited the consolidated balance sheets of Avista Corporation and subsidiaries (the "Company") as of December 31, 2004 and 2003, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows, which include the schedule of information by business segments, for each of the three years in the period ended December 31, 2004. We also have audited management's assessment of the effectiveness of the Company's internal control over financial reporting and the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. Such consolidated financial statements, management's assessment of the effectiveness of the Company's internal control over financial reporting and our reports thereon dated March 9, 2005, expressing unqualified opinions (which opinion on the consolidated financial statements includes an explanatory paragraph for certain changes in accounting and presentation resulting from the impact of recently adopted accounting standards), which are not included herein, are included in Appendix A to the 2004 annual report. The accompanying condensed consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on such condensed consolidated financial statements in relation to the complete consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated balance sheets as of December 31, 2004 and 2003, and the related condensed consolidated statements of income and of cash flows for each of the three years in the period ended December 31, 2004, is fairly stated in all material respects in relation to the basic consolidated financial statements from which it has been derived.



Seattle, Washington
March 9, 2005

Management's Statement of Responsibility

The condensed consolidated financial statements in this summary annual report were derived from the consolidated financial statements that appear in Appendix A to the 2004 annual report. Management of Avista Corporation is responsible for the accuracy and completeness of the information in this summary annual report. The financial and operating information is derived from company records and includes amounts based on judgment and estimates where necessary. Disclosure controls and procedures in combination with the company's internal control over financial reporting provide reasonable assurance that the summary annual report fairly and reasonably presents the company's financial position and operating results.

The board of directors appointed Deloitte & Touche LLP, an independent registered public accounting firm, to audit the consolidated financial statements included in Appendix A to the 2004 annual report. Their report on the condensed consolidated financial statements appears above.



Gary G. Ely
Chairman, President and
Chief Executive Officer



Malyn K. Malquist
Senior Vice President,
Chief Financial Officer and Treasurer

Condensed Consolidated Statements of Income*(For the Years Ended December 31 – Dollars in Thousands, Except Per Share Amounts)*

	2004	2003	2002
Operating Revenues	<u>\$ 1,151,580</u>	<u>\$ 1,123,385</u>	<u>\$ 1,062,916</u>
Operating Expenses			
Resource costs	604,984	576,492	536,714
Operations and maintenance	155,944	138,058	125,930
Administrative and general	104,266	97,494	105,647
Depreciation and amortization	78,425	77,811	71,867
Taxes other than income taxes	<u>67,491</u>	<u>61,827</u>	<u>65,616</u>
Total operating expenses	<u>1,011,110</u>	<u>951,682</u>	<u>905,774</u>
Income From Operations	<u>140,470</u>	<u>171,703</u>	<u>157,142</u>
Other Income (Expense)			
Interest expense	(87,265)	(91,505)	(104,866)
Interest expense to affiliated trusts	(5,782)	(1,480)	–
Capitalized interest	<u>1,393</u>	<u>1,092</u>	<u>7,486</u>
Net interest expense	(91,654)	(91,893)	(97,380)
Other income – net	<u>8,390</u>	<u>6,173</u>	<u>17,261</u>
Total other income (expense) – net	<u>(83,264)</u>	<u>(85,720)</u>	<u>(80,119)</u>
Income From Continuing Operations Before Income Taxes	57,206	85,983	77,023
Income Taxes	<u>21,592</u>	<u>35,340</u>	<u>34,849</u>
Income From Continuing Operations	35,614	50,643	42,174
Loss From Discontinued Operations	<u>–</u>	<u>(4,949)</u>	<u>(6,719)</u>
Net Income Before Cumulative Effect of Accounting Change	35,614	45,694	35,455
Cumulative Effect of Accounting Change (net of tax)	<u>(460)</u>	<u>(1,190)</u>	<u>(4,148)</u>
Net Income	35,154	44,504	31,307
Deduct – Preferred stock dividend requirements	<u>–</u>	<u>1,125</u>	<u>2,402</u>
Income Available for Common Stock	<u>\$ 35,154</u>	<u>\$ 43,379</u>	<u>\$ 28,905</u>
Earnings Per Common Share, Basic			
Earnings per common share from continuing operations	\$ 0.74	\$ 1.03	\$ 0.83
Loss per common share from discontinued operations	<u>–</u>	<u>(0.10)</u>	<u>(0.14)</u>
Earnings per common share before cumulative effect of accounting change	0.74	0.93	0.69
Loss per common share from cumulative effect of accounting change	<u>(0.01)</u>	<u>(0.03)</u>	<u>(0.09)</u>
Total earnings per common share, basic	<u>\$ 0.73</u>	<u>\$ 0.90</u>	<u>\$ 0.60</u>
Earnings Per Common Share, Diluted			
Earnings per common share from continuing operations	\$ 0.73	\$ 1.02	\$ 0.83
Loss per common share from discontinued operations	<u>–</u>	<u>(0.10)</u>	<u>(0.14)</u>
Earnings per common share before cumulative effect of accounting change	0.73	0.92	0.69
Loss per common share from cumulative effect of accounting change	<u>(0.01)</u>	<u>(0.03)</u>	<u>(0.09)</u>
Total earnings per common share, diluted	<u>\$ 0.72</u>	<u>\$ 0.89</u>	<u>\$ 0.60</u>
Dividends paid per common share	\$ 0.515	\$ 0.490	\$ 0.480

Condensed Consolidated Balance Sheets*(As of December 31 - Dollars in Thousands)*

	2004	2003
Assets		
Cash and cash equivalents	\$ 88,317	\$ 128,126
Restricted cash	26,175	16,472
Securities held for trading	—	18,903
Accounts and notes receivable	325,755	318,848
Current energy commodity assets	284,231	253,676
Other current assets	175,864	127,554
Total net utility property	1,956,063	1,914,001
Investment in exchange power – net	35,933	38,383
Nonutility properties and investments – net	78,564	89,133
Noncurrent energy commodity assets	254,657	242,359
Investment in affiliated trusts	13,403	13,403
Other property and investments – net	19,721	17,958
Regulatory assets for deferred income tax	123,159	131,763
Other regulatory assets	39,044	44,381
Noncurrent utility energy commodity derivative assets	55,825	34,517
Power and natural gas deferrals	148,206	171,342
Unamortized debt expense	53,413	48,825
Other deferred charges	25,493	30,431
Total Assets	\$ 3,703,823	\$ 3,640,075
Liabilities and Stockholders' Equity		
Accounts payable	\$ 325,194	\$ 298,285
Current energy commodity liabilities	253,527	229,642
Deposits from counterparties	6,015	97,811
Current portion of long-term debt	85,432	29,711
Short-term borrowings	68,517	80,525
Other current liabilities	135,355	116,578
Long-term debt	901,556	925,012
Long-term debt to affiliated trusts	113,403	113,403
Preferred stock (subject to mandatory redemption)	28,000	29,750
Noncurrent energy commodity liabilities	215,055	192,731
Regulatory liability for utility plant retirement costs	175,575	167,061
Noncurrent utility energy commodity derivative liabilities	33,490	33,060
Deferred income taxes	488,471	492,799
Other noncurrent liabilities and deferred credits	121,028	82,455
Total Liabilities	\$ 2,950,618	\$ 2,888,823
Common stock – net (48,471,511 and 48,344,009 outstanding shares)	617,884	613,414
Retained earnings and accumulated other comprehensive loss	135,321	137,838
Total Stockholders' Equity	\$ 753,205	\$ 751,252
Total Liabilities and Stockholders' Equity	\$ 3,703,823	\$ 3,640,075

Condensed Consolidated Statements of Cash Flows
Increase (Decrease) in Cash and Cash Equivalents (For the Years Ended December 31 – Dollars in Thousands)

	2004	2003	2002
Continuing Operating Activities:			
Net income	\$ 35,154	\$ 44,504	\$ 31,307
Loss from discontinued operations	—	4,949	6,719
Cumulative effect of accounting change	460	1,190	4,148
Purchases of securities held for trading	(15,260)	(18,865)	—
Sales of securities held for trading	34,192	—	—
Noncash items included in net income:			
Depreciation and amortization	78,425	77,811	71,867
Provision for deferred income taxes	19,168	28,395	(40,287)
Power and natural gas cost amortizations, net of deferrals	11,087	3,829	68,481
Amortization of debt expense	8,301	7,972	8,861
Write-offs and impairment of assets	21,990	4,900	—
Energy commodity assets and liabilities	678	22,128	87,403
Other	3,770	(11,214)	(10,763)
Changes in working capital components	(89,623)	(43,035)	99,124
Net Cash Provided by Continuing Operating Activities	<u>108,342</u>	<u>122,564</u>	<u>326,860</u>
Continuing Investing Activities:			
Utility property capital expenditures (excluding AFUDC)	(115,346)	(102,271)	(64,207)
Other capital expenditures	(3,126)	(3,388)	(18,873)
Repayments received on notes receivable	1,062	1,214	33,752
Other	(2,017)	(5,404)	1,543
Net Cash Used in Continuing Investing Activities	<u>(119,427)</u>	<u>(109,849)</u>	<u>(47,785)</u>
Continuing Financing Activities:			
Increase (decrease) in short-term borrowings	(12,008)	50,525	(45,099)
Proceeds from issuance of long-term debt	89,761	44,795	621
Redemption and maturity of long-term debt	(66,857)	(124,859)	(204,014)
Proceeds from issuance of long-term debt to affiliated trusts	61,856	—	—
Redemption of long-term debt to affiliated trusts	(61,856)	—	—
Redemption of preferred stock	(1,750)	(1,575)	(1,750)
Issuance of common stock	4,061	5,497	7,035
Cash dividends paid	(24,912)	(24,777)	(25,456)
Other	(17,019)	(4,139)	(15,990)
Net Cash Used in Continuing Financing Activities	<u>(28,724)</u>	<u>(54,533)</u>	<u>(284,653)</u>
Net Cash Used in Continuing Operations	(39,809)	(41,818)	(5,578)
Net Cash Provided by (Used in) Discontinued Operations	—	(3,342)	8,967
Net Increase (Decrease) in Cash and Cash Equivalents	(39,809)	(45,160)	3,389
Cash and Cash Equivalents at Beginning of Period	<u>128,126</u>	<u>173,286</u>	<u>169,897</u>
Cash and Cash Equivalents at End of Period	<u>\$ 88,317</u>	<u>\$ 128,126</u>	<u>\$ 173,286</u>

Financial Summary

The following is a brief discussion and analysis of financial condition and results of operations for Avista Corporation (Avista Corp. or the Company). For a more detailed analysis, please refer to Appendix A to the 2004 annual report.

Summary of Results – Income from continuing operations was \$35.6 million for 2004 compared to \$50.6 million for 2003. This decrease was primarily due to the Idaho general rate case write-offs of \$14.4 million (\$9.4 million, net of tax) recorded at Avista Utilities, as well as reduced earnings for Avista Energy (Energy Marketing and Resource Management segment) and an increase in the net loss for the Other business segment. This was partially offset by the improved performance of Avista Utilities (excluding the Idaho write-offs) due to general rate increases, as well as net earnings from Avista Advantage for 2004 as compared to a net loss for 2003.

Avista Corp.'s net income and operating cash flows are derived primarily from Avista Utilities and Avista Energy. Avista Corp. intends to continue to focus on improving earnings and operating cash flows, controlling costs and reducing debt while working to restore an investment-grade credit rating.

Avista Utilities expects to continue to be among the industry leaders in performance, value and service in its electric and natural gas utility businesses. Avista Utilities expects to continue its modest, yet steady, combined growth of electric and natural gas customers of 2 to 3 percent per year primarily from economic and population growth in its service territory. As part of Avista Utilities' strategy to focus on its business in the northwestern United States, the Company has entered into an agreement to sell its natural gas distribution properties in South Lake Tahoe, California.

It is Avista Utilities' strategy to own or to have contracts that provide a sufficient amount of electric resources to meet its retail and wholesale energy requirements under a range of operating conditions. Available resources and the costs of those resources are significantly affected by Avista Utilities' hydroelectric generation, which was 95 percent of normal in 2004. Based on forecasts as of March 1, 2005, Avista Utilities expects hydroelectric generation will be approximately 84 percent of normal in 2005, assuming normal precipitation for the remainder of the year. This expectation may change based upon precipitation, temperatures and other variables. The earnings impact of below normal hydroelectric generation is mitigated through power cost deferral and recovery mechanisms in Washington and Idaho. The expected reduction in hydroelectric generation is estimated to have a negative effect on operating cash flows of approximately \$25 million from the amount originally forecasted, with approximately \$2.5 million impacting pre-tax earnings.

Customer loads and resulting revenues are also significantly affected by weather, which causes changes in energy usage from season to season and from month to month within a season. Although there were differences with respect to quarter-to-quarter comparisons, total heating and cooling degree days at Spokane, Washington for both 2004 and 2003 were similar with both warmer than normal heating and cooling seasons. As such, electric and natural gas loads, revenues and net income were not significantly affected by weather when comparing 2004 to 2003 results.

As is the case with most regulated entities, Avista Utilities generally has ongoing regulatory proceedings. Avista Utilities continues to make progress with respect to resolving its regulatory matters; however, certain issues remain unresolved. Avista Utilities received the following general rate increases in 2004 and 2003: (1) Oregon natural gas in September 2003; (2) Idaho electric and natural gas in September 2004; and (3) Washington natural gas in November 2004. These general rate increases have increased revenues and net income for 2004 as compared to 2003 and should result in increased net income in 2005 as compared to 2004. Avista Utilities will continue to file for rate adjustments to provide recovery of its costs and to more closely align earned returns with those allowed by regulatory agencies in each jurisdiction.

Net income for Avista Utilities was \$32.5 million for 2004, compared to \$36.2 million for 2003. The decrease for Avista Utilities was primarily due to the Idaho general rate case write-offs. Excluding the write-offs, net income increased primarily due to an increase in gross margin as a result of general rate increases, partially offset by an increase in other operating expenses. The Company expects Avista Utilities' net income for 2005 to increase as compared to 2004, primarily due to the continued effect of general rate increases, subject to the influence of weather.

Avista Energy focuses on optimization of combustion turbines and

hydroelectric assets owned by other entities, long-term electric supply contracts, natural gas storage, and electric transmission and natural gas transportation arrangements. Avista Energy is also involved in trading electricity and natural gas, including derivative commodity instruments. Avista Energy Canada, Ltd. (Avista Energy Canada) is a wholly owned subsidiary of Avista Energy that provides natural gas services to approximately 250 industrial and commercial customers that represent over 400 sites in British Columbia, Canada. In addition to earnings and resulting cash flows from settled or realized transactions, Avista Energy records unrealized or mark-to-market adjustments for the change in the value of derivative commodity instruments. Avista Energy's marketing, trading and resource management activities are driven by its base of knowledge and experience in the operation of both electric energy and natural gas physical systems in the Western Electricity Coordinating Council, as well as its relationship-focused approach with its customers.

Avista Energy is subject to certain regulatory proceedings that remain unresolved; however, Avista Energy believes that it has adequate reserves established for refunds that may be ordered. The wholesale power markets in which Avista Energy operates continue to change with respect to market participants involved, level of activity, volatility in market prices, liquidity, regulatory imposed price caps and counterparty credit issues.

Net income for Energy Marketing and Resource Management was \$9.7 million for 2004 compared to \$20.7 million (excluding the cumulative effect of accounting change) for 2003. This decrease was primarily due to the positive effects in 2003 of accounting for energy trading activities under Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," and the settlement of positions with certain Enron Corporation (Enron) affiliates. In addition, Avista Energy's earnings were decreased due to lower natural gas trading margins in 2004 as compared to 2003. These decreases were partially offset by portfolio valuation adjustments at Avista Energy of approximately \$2.9 million, net of tax, the most significant of which relates to increases in market liquidity in the Western power markets. Both 2004 and 2003 net income for the Energy Marketing and Resource Management segment were decreased by impairment charges for a turbine and related equipment owned by Avista Power. The Company does not expect these factors to occur in 2005.

Avista Advantage had net income of \$0.6 million for 2004 compared to a net loss of \$1.3 million for 2003. The change was primarily due to an increase in operating revenues, partially offset by the settlement of an employment contract. Avista Advantage remains focused on increasing revenues, controlling operating expenses, continuously enhancing client satisfaction and developing complementary value-added services. The Company expects that net income for Avista Advantage for 2005 will increase as compared to 2004 based on improving revenues and stabilized operating expenses from processing efficiencies.

The Other business segment incurred a net loss of \$7.2 million (excluding the cumulative effect of accounting change) for 2004 compared to a net loss of \$4.9 million for 2003. The increase in the net loss was primarily due to the impairment of goodwill at Advanced Manufacturing and Development (AM&D) doing business as METAL6x, the write-off of an investment in a natural gas storage project, the accrual of an environmental liability at Avista Development and Avista Capital's purchase of Avista Advantage preferred stock at a premium. Over time as opportunities arise, the Company plans to continue to dispose of assets and phase out operations in the Other business segment. The Company expects the net loss in the Other business segment to be less for 2005 as compared to 2004 due to decreased losses from asset impairments and write-offs.

During 2005, the Company expects cash flows from operations and Avista Corp.'s five-year \$350.0 million committed line of credit to provide adequate resources to fund capital expenditures, maturing long-term debt (excluding \$54.6 million of maturing WP Funding LP debt) and other contractual commitments. However, if market conditions warrant such actions, the Company may issue securities to fund these obligations, refinance existing debt and repurchase long-term debt scheduled to mature in future years to reduce its overall debt service costs, as well as to manage the risk associated with future changes in interest rates on debt maturities scheduled for 2007 and 2008.

Overall Results of Operations – Total revenues increased \$28.2 million for 2004 compared to 2003. Avista Utilities' revenues increased \$44.4 million due to increases in both electric and natural gas revenues. The increase in natural gas revenues was primarily due to natural gas rate increases implemented during 2004 and 2003 and partially due to

increased terms sold, primarily as a result of customer growth. The increase in electric revenues reflects an increase in retail revenues, partially offset by a decrease in wholesale revenues and sales of fuel. Revenues from Energy Marketing and Resource Management decreased \$31.5 million primarily due to decreased net trading margin on contracts accounted for under SFAS No. 133, a settlement with Enron affiliates during 2003 and decreased revenues under the Agency Agreement with Avista Utilities, partially offset by increased revenues for Avista Energy Canada. Revenues from Avista Advantage increased \$3.6 million to \$23.4 million primarily as a result of customer growth. Revenues from the Other business segment increased \$3.5 million to \$17.1 million primarily due to increased revenues from AM&D as well as revenues from entities consolidated in 2004 under Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities," which was revised in December 2003 (collectively referred to as FIN 46).

Total resource costs increased \$28.5 million for 2004 compared to 2003. Resource costs for Avista Utilities increased \$30.5 million primarily due to an increase in purchased natural gas costs as well as the write-off of \$12.0 million of deferred power costs resulting from the Idaho general rate case order. This increase in purchased natural gas costs was primarily due to an increase in prices and partially due to an increase in the volume purchased due to customer growth. Resource costs for Energy Marketing and Resource Management decreased \$10.1 million primarily due to decreased resource costs for Avista Energy Canada and decreased resource costs under the Agency Agreement with Avista Utilities.

Intersegment eliminations, which decrease both operating revenues and resource costs, were \$137.2 million for 2004 compared to \$145.4 million for 2003, representing decreased purchases of natural gas under the Agency Agreement between Avista Utilities and Avista Energy.

Operations and maintenance expenses increased \$17.9 million for 2004 compared to 2003 partially due to the disallowance in the Idaho general rate case of \$2.4 million (net of \$0.3 million of accumulated depreciation) of certain capitalized utility plant costs at Avista Utilities. The remaining increase for Avista Utilities was primarily due to a general increase in operations and maintenance expense primarily related to distribution and customer service expenses, partially reflecting an increase in labor costs. Operations and maintenance expense for the Other business segment increased \$2.6 million due to the write-off of an investment in a natural gas storage project as well as the effects from entities consolidated under FIN 46.

Administrative and general expenses increased \$6.8 million for 2004 compared to 2003 primarily due to increased expenses for Avista Utilities, Avista Advantage and the Other business segment, partially offset by decreased expenses for Energy Marketing and Resource Management. The decrease for Energy Marketing and Resource Management was primarily a result of decreased compensation expenses and professional fees. The increase for Avista Utilities primarily reflects an increase in labor costs and other employee-related expenses, increased liability and damage claims insurance costs, as well as an increase in outside services. The increase for Avista Advantage was primarily due to the settlement of an employment contract. The increase for the Other business segment primarily reflects the impairment of goodwill at AM&D and the accrual of an environmental liability at Avista Development.

Depreciation and amortization increased \$0.6 million for 2004 compared to 2003 primarily due to utility plant additions at Avista Utilities and the resulting increase in depreciation expense, as well as the consolidation of WP Funding LP under FIN 46 and the resulting inclusion of depreciation expense of the Rathdrum Power Plant. This was partially offset by a correction at Avista Utilities for overstated depreciation expense in prior periods recorded during 2004. Coyote Springs 2 was placed into service in mid-2003 and increased depreciation expense for 2004 as compared to 2003.

Taxes other than income taxes increased \$5.7 million for 2004 compared to 2003 primarily due to increased retail revenues and related taxes for Avista Utilities. An increase in property taxes at Avista Utilities also contributed to the increase in taxes other than income taxes.

Interest expense (including interest expense to affiliated trusts) increased \$0.1 million for 2004 compared to 2003 primarily due to the inclusion of the interest expense on \$54.6 million of debt of WP Funding LP, which was consolidated for all of 2004 and only the fourth quarter of 2003 as required by FIN 46, as well as an increase in interest on short-term borrowings and the inclusion of preferred stock dividends as interest expense in accordance with SFAS No. 150, partially offset by a decrease in interest expense on long-term debt due to the repurchase of higher cost debt. Preferred stock dividends of \$1.1 million, distributed prior to

the adoption of SFAS No. 150 on July 1, 2003, were classified as a separate line item in the Consolidated Statement of Income for 2003.

Other income-net increased \$2.2 million for 2004 compared to 2003 primarily due to increased income in 2004 on certain investments in the Other business segment and net gains on the disposition of non-operating assets in 2004 compared to net losses in 2003. This was partially offset by the premium paid on the repurchase of Avista Advantage preferred stock, as well as a decrease in interest income and interest on power and natural gas deferrals.

Income taxes decreased \$13.7 million for 2004 compared to 2003, primarily due to decreased income before income taxes. The effective tax rate was 37.7 percent for 2004 compared to 41.1 percent for 2003.

During 2004, the Other business segment recorded as a cumulative effect of accounting change a charge of \$0.5 million related to the implementation of FIN 46, which required Avista Ventures to consolidate several minor entities.

Liquidity and Capital Resources – Since 2002, the Company's overall liquidity has improved compared to 2001. The general rate increases that became effective in 2002, 2003 and 2004 are allowing the Company to continue to improve its liquidity.

In 2001, the Company incurred substantial levels of indebtedness, both short- and long-term, to fund high power and natural gas costs in addition to continuing capital and operating requirements and to otherwise maintain adequate levels of working capital. As a result of improved operating cash flow and other sources of funds, since 2002 through 2004, the Company has repurchased \$292.7 million of long-term debt.

The Company's total debt increased from December 31, 2003 to December 31, 2004 due to the issuance of long-term debt, partially offset by a decrease in short-term borrowings and the repurchase and maturity of long-term debt. The Company's consolidated common equity increased \$2.0 million during 2004 primarily due to net income and the issuance of common stock through the Dividend Reinvestment Plan, partially offset by dividends and other comprehensive loss.

In April 2004, the Company issued Junior Subordinated Debt Securities, with a principal amount of \$61.9 million to AVA Capital Trust III, an affiliated business trust formed by the Company. Concurrently, AVA Capital Trust III issued \$60.0 million of Preferred Trust Securities to third parties and \$1.9 million of Common Trust Securities to the Company. All of these securities have a fixed interest rate of 6.50 percent for five years (through March 31, 2009). Subsequent to the initial five-year fixed rate period, the securities will either have a new fixed rate or an adjustable rate. These debt securities may be redeemed by the Company on or after March 31, 2009 and will mature on April 1, 2034.

The Company used the proceeds from the Junior Subordinated Debt Securities to redeem \$61.9 million of 7.875 percent Junior Subordinated Deferrable Interest Debentures, Series A, originally issued in 1997 to Avista Capital I, an affiliated business trust formed by the Company. Avista Capital I used these proceeds to redeem \$60.0 million of Preferred Trust Securities issued to third parties and \$1.9 million of Common Trust Securities issued to the Company.

In November 2004, the Company issued \$90.0 million of 5.45 percent First Mortgage Bonds due in 2019. The Company used the proceeds to repay a portion of the borrowings outstanding under its committed line of credit.

In December 2004, the Company entered into a five-year committed line of credit with various banks in the amount of \$350.0 million. This committed line of credit replaced a \$350.0 million committed line of credit with a 364-day term that had an expiration date of May 5, 2005. The Company can request the issuance of up to \$150.0 million in letters of credit under the committed line of credit. As of December 31, 2004, the Company had \$68.0 million of borrowings outstanding under this committed line of credit.

Pension Plan – As of December 31, 2004, the Company's pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. The Company does not expect the current pension plan funding deficit to have a material adverse impact on its financial condition, results of operations or cash flows. The Company made \$15 million in cash contributions to the pension plan in 2004 and \$12 million in 2003. The Company expects to make pension plan contributions of \$15 million in 2005.

AVISTA UTILITIES SERVICE TERRITORY



Our 30,000-square-mile service territory includes energy generation, transmission and distribution operations in five Western states. We provide electricity to more than 330,000 customers in eastern Washington and northern Idaho. Our approximately 305,000 natural gas customers are located in Washington, Idaho, Oregon and California.

Corporate Information

Company Headquarters

Avista Corp.
1411 East Mission Avenue
Spokane, Washington 99202

Avista Corp. on the Internet

Financial results, stock quotes, news releases, documents filed with the Securities and Exchange Commission, and information on the company's products and services are available at Avista Corp.'s Web site. The address is www.avistacorp.com.

Transfer Agent

The Bank of New York is the company's stock transfer, dividend payment and reinvestment plan agent. Answers to many shareholder questions and requests for forms are available by visiting The Bank of New York's Web site at www.stockbny.com.

Inquiries should be directed to:

The Bank of New York
Shareholder Relations Department
P.O. Box 11258
Church Street Station
New York, New York 10286-1258
800.642.7365
shareowners@bankofny.com

Investor Information

A copy of the company's financial reports, including the reports on Forms 10-K and 10-Q filed with the Securities and Exchange Commission, will be provided, without charge, upon request to: Avista Corp.

Investor Relations
P.O. Box 3727 MSC-19
Spokane, Washington 99220-3727
800.222.4931

Annual Meeting of Shareholders

Shareholders are invited to attend the company's annual meeting to be held at 10 a.m. PDT on Thursday, May 12, 2005, at Avista Corp. headquarters, 1411 East Mission Avenue in Spokane, Washington.

The annual meeting also will be webcast. Please go to www.avistacorp.com to preregister for the webcast in advance of the annual meeting and to listen to the live webcast. The webcast will be archived at www.avistacorp.com for one year to allow shareholders to listen to it at their convenience.

Exchange Listings

Ticker Symbol: AVA
New York Stock Exchange
Pacific Exchange

AVA
LISTED
NYSE

Certifications

On June 7, 2004, the Chief Executive Officer of Avista Corp. filed a Section 303A.12(a) CEO Certification with the New York Stock Exchange. The CEO Certification attests that the Chief Executive Officer is not aware of any violations by the Company of NYSE's Corporate Governance Listing Standards.

On March 11, 2005, Avista Corp. filed the CEO/CFO certifications with the Securities and Exchange Commission as exhibits to its Form 10-K in compliance with the Sarbanes-Oxley Act.

This annual report contains forward-looking statements regarding the company's current expectations. These statements are subject to a variety of risks and uncertainties that could cause actual results to differ materially from the expectations. These risks and uncertainties include, in addition to those discussed herein, all factors discussed in the company's annual report on Form 10-K for the year 2004.

Our 2004 annual report is provided for investors. It is not intended for use in connection with any sale or purchase of or any solicitation of others to buy or sell securities.

© 2005, Avista Corp. All rights reserved.

Special thanks to these talented companies of the great Inland Northwest for their help with this year's annual report:

Anderson Mraz Design (design)

Sharman Communications (writing)

J. Craig Sweat Photography (principal photography)

Lawton Printing (printing and bindery)

Additional photography by: Tim Hall (FPL Energy's Stateline Wind Energy Center), Dustin Snipes (Avista Stadium) and Scott Spiker (Schweitzer Ski Resort)

Avista Utilities

Avista Energy

Avista Advantage

AVISTA

Corp.

Avista Corp.

East Mission Avenue

Spokane, Washington 99202

800-891-0500

www.avistacolorado.com



2004 FINANCIAL REPORT

APPENDIX A



Table of Contents

	<u>Page</u>
Management's Discussion and Analysis of Financial Condition and Results of Operations	1
Consolidated Statements of Income	41
Consolidated Statements of Comprehensive Income	42
Consolidated Balance Sheets	43-44
Consolidated Statements of Cash Flows	45-46
Consolidated Statements of Stockholders' Equity	47
Schedule of Information by Business Segments	48-49
Notes to Consolidated Financial Statements	50
Management's Reports to Avista Corporation Stockholders	90
Reports of Independent Registered Public Accounting Firm	91-93
Selected Financial Data	94

Avista Corporation
P. O. Box 3727
1411 East Mission Avenue
Spokane, WA 99220-3727

Phone: (509) 489-0500
Web site: www.avistacorp.com

Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

Avista Corporation (Avista Corp. or the Company) from time to time makes forward-looking statements such as statements regarding future financial performance, capital expenditures, dividends, capital structure and other financial items, including the underlying assumptions (many of which are based, in turn, upon further assumptions), as well as strategic goals and objectives and plans for future operations. Such statements are made both in Avista Corp.'s reports filed under the Securities Exchange Act of 1934, as amended (including this Annual Report on Form 10-K), and elsewhere. Forward-looking statements are all statements other than statements of historical fact, including, without limitation, those that are identified by the use of words such as, but not limited to, "will," "may," "could," "should," "intends," "plans," "seeks," "anticipates," "estimates," "expects," "projects," "predicts," and similar expressions.

All forward-looking statements (including those made in this Annual Report) are subject to a variety of risks and uncertainties and other factors, most of which are beyond the control of Avista Corp. and many of which could have a significant impact on Avista Corp.'s operations, results of operations, financial condition or cash flows and could cause actual results to differ materially from those anticipated in such statements. Such risks, uncertainties and other factors include, among others:

- changes in the utility regulatory environment in the individual states and provinces in which the Company operates as well as the United States and Canada in general, which can impact allowed rates of return, financings, or industry and rate structures;
- the impact of regulatory decisions including Federal Energy Regulatory Commission (FERC) price controls, and including possible retroactive price caps and resulting refunds;
- the potential effects of any legislation or administrative rulemaking passed into law;
- the impact from the potential formation of a Regional Transmission Organization and/or an Independent Transmission Company;
- the impact from the potential implementation of the FERC's proposed wholesale power market rules;
- the ability to relicense the Spokane River Project at a cost-effective level with reasonable terms and conditions;
- volatility and illiquidity in wholesale energy markets, including the availability and prices of purchased energy and demand for energy sales;
- changes in wholesale energy prices that can affect, among other things, the market value of derivative assets and liabilities and unrealized gains and losses, as well as cash requirements to purchase electricity and natural gas for retail customers;
- changes in global energy markets that can affect, among other things, the price of natural gas purchased for retail customers and purchased as fuel for electric generation;
- wholesale and retail competition (including, but not limited to, electric retail wheeling and transmission costs);
- future streamflow conditions that affect the availability of hydroelectric resources;
- unplanned outages at any Company-owned generating facilities;
- unanticipated delays or changes in construction costs with respect to present or prospective facilities;
- changes in weather conditions that can affect customer demand, result in natural disasters and/or disrupt energy delivery;
- changes in industrial, commercial and residential growth and demographic patterns in the Company's service territory;
- the loss of significant customers and/or suppliers;
- failure to deliver on the part of any parties from which the Company purchases and/or sells capacity or energy;
- changes in the creditworthiness of customers and energy trading counterparties;
- the Company's ability to obtain financing through the issuance of debt and/or equity securities, which can be affected by various factors including the Company's credit ratings, interest rate fluctuations and other capital market conditions;
- the impact of any potential change in the Company's credit ratings, including the effect on Avista Energy's credit facility;
- changes in future economic conditions in the Company's service territory and the United States in general, including inflation or deflation and monetary policy;
- changes in rapidly advancing technologies, possibly making some of the current technology quickly obsolete;
- the potential for future terrorist attacks, particularly with respect to utility plant assets;
- changes in tax rates and/or policies;

- changes in, and compliance with, environmental and endangered species laws, regulations, decisions and policies, including present and potential environmental remediation costs;
- the outcome of legal and regulatory proceedings concerning the Company or affecting directly or indirectly its operations, including the potential disallowance of previously deferred costs;
- employee issues, including changes in collective bargaining unit agreements, strikes, work stoppages or the loss of key executives, as well as the ability to recruit and retain employees;
- changes in actuarial assumptions and the return on assets with respect to the Company's pension plan, which can impact future funding obligations, costs and pension plan liabilities;
- increasing health care costs and the resulting effect on health insurance premiums paid for employees and on the obligation to provide postretirement health care benefits; and
- increasing costs of insurance, changes in coverage terms and the ability to obtain insurance.

The Company's expectations, beliefs and projections are expressed in good faith and are believed by the Company to have a reasonable basis including, without limitation, management's examination of historical operating trends, data contained in the Company's records and other data available from third parties. However, there can be no assurance that the Company's expectations, beliefs or projections will be achieved or accomplished. Furthermore, any forward-looking statement speaks only as of the date on which such statement is made. The Company undertakes no obligation to update any forward-looking statement or statements to reflect events or circumstances that occur after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for management to predict all of such factors, nor can it assess the impact of each such factor on the Company's business or the extent to which any such factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement.

The following discussion and analysis is provided for the consolidated financial condition and results of operations of Avista Corp., including its subsidiaries. This discussion focuses on significant factors concerning the Company's financial condition and results of operations and should be read along with the consolidated financial statements.

Avista Corp. Business Segments

Avista Corp. is an energy company engaged in the generation, transmission and distribution of energy as well as other energy-related businesses. The Company has four business segments – Avista Utilities, Energy Marketing and Resource Management, Avista Advantage and Other. Avista Utilities is an operating division of Avista Corp. comprising the regulated utility operations. Avista Utilities generates, transmits and distributes electricity and distributes natural gas. Avista Capital, a wholly owned subsidiary of Avista Corp., is the parent company of all of the subsidiary companies in the non-utility business segments. As of December 31, 2004, the Company had common equity investments of \$495.8 million and \$257.4 million in Avista Utilities and Avista Capital, respectively.

The Energy Marketing and Resource Management business segment is comprised of Avista Energy, Inc. (Avista Energy) and Avista Power, LLC (Avista Power). Avista Energy is an electricity and natural gas marketing, trading and resource management business, operating primarily in the Western Electricity Coordinating Council (WECC) geographical area, which is comprised of eleven Western states and the provinces of British Columbia and Alberta, Canada. Avista Power is an investor in certain generation assets, primarily its 49 percent interest in a 270 MW natural gas-fired combined cycle combustion turbine plant in northern Idaho (Lancaster Project).

Avista Advantage, Inc. (Avista Advantage) is a provider of utility bill processing, payment and information services to multi-site customers throughout North America. Its primary product lines include consolidated billing, resource accounting, energy analysis and load profiling services.

The Other business segment includes Avista Ventures, Inc. (Avista Ventures), Pentzer Corporation (Pentzer), Avista Development and certain other operations of Avista Capital. Included in this business segment is Advanced Manufacturing and Development (AM&D) doing business as METALfx, a subsidiary of Avista Ventures that performs custom sheet metal manufacturing of electronic enclosures, parts and systems for the computer, telecom and medical industries. AM&D also provides complete fabrication and turnkey assembly for arcade games, kiosks, store fixtures and displays. Other significant investments in this segment include commercial office buildings, investments in low income housing and venture capital partnerships, the remaining investment in a previous fuel cell subsidiary of the Company, and notes receivable from the sale of property and investments.

Executive Level Summary

Avista Corp.'s net income and operating cash flows are derived primarily from Avista Utilities and Avista Energy (included in the Energy Marketing and Resource Management segment). Avista Corp. intends to continue to focus on improving earnings and operating cash flows, controlling costs and reducing debt while working to restore an investment grade credit rating.

Avista Utilities expects to continue to be among the industry leaders in performance, value and service in its electric and natural gas utility businesses. Avista Utilities expects to continue its modest, yet steady, combined growth of electric and natural gas customers of 2 to 3 percent per year primarily from economic and population growth in its service territory. As part of Avista Utilities' strategy to focus on its business in the northwestern United States, the Company has entered into an agreement to sell its natural gas distribution properties in South Lake Tahoe, California (see "Note 27 of the Notes to Consolidated Financial Statements").

It is Avista Utilities' strategy to own or to have contracts that provide a sufficient amount of electric resources to meet its retail and wholesale energy requirements under a range of operating conditions. Available resources and the costs of those resources are significantly affected by Avista Utilities' hydroelectric generation, which was 95 percent of normal in 2004. Based on forecasts as of March 1, 2005, Avista Utilities expects hydroelectric generation will be approximately 84 percent of normal in 2005 assuming normal precipitation for the remainder of the year. This expectation may change based upon precipitation, temperatures and other variables. The earnings impact of below normal hydroelectric generation is mitigated through power cost deferral and recovery mechanisms in Washington and Idaho. The expected reduction in hydroelectric generation is estimated to have a negative effect on operating cash flows of approximately \$25 million from the amount originally forecasted, with approximately \$2.5 million impacting pre-tax earnings. Avista Utilities believes that it has adequate liquidity through cash flows generated from operations and funds available under its committed line of credit to meet increased cash requirements for purchased power or fuel as a result of reduced hydroelectric generation.

Customer loads and resulting revenues are also significantly affected by weather, which causes changes in energy usage from season to season and from month to month within a season. Changes in wholesale electric prices and the amount of hydroelectric generation available to Avista Utilities also make quarter-to-quarter comparisons difficult. Avista Utilities normally experiences its highest retail energy sales during the heating season in the first and fourth quarters of the year. Although there were differences with respect to quarter-to-quarter comparisons, total heating and cooling degree days at Spokane, Washington for both 2004 and 2003 were similar with both warmer than normal heating and cooling seasons. As such, electric and natural gas loads, revenues and net income were not significantly affected by weather when comparing 2004 to 2003 results.

As is the case with most regulated entities, Avista Utilities generally has ongoing regulatory proceedings. Avista Utilities continues to make progress with respect to resolving its regulatory matters; however, certain issues remain unresolved. Avista Utilities received the following general rate increases in 2004 and 2003: (1) Oregon natural gas in September 2003; (2) Idaho electric and natural gas in September 2004; and (3) Washington natural gas in November 2004. These general rate increases have increased revenues and net income for 2004 as compared to 2003 and should result in increased net income in 2005 as compared to 2004. Avista Utilities will continue to file for rate adjustments to provide recovery of its costs and to more closely align earned returns with those allowed by regulatory agencies in each jurisdiction.

Avista Utilities' net income decreased in 2004 as compared to 2003 primarily due to write-offs related to the Idaho general electric rate case, which was partially offset by the general rate increases described above. The Company expects Avista Utilities' net income for 2005 to increase as compared to 2004 primarily due to the continued effect of general rate increases, subject to the influence of weather.

The Company has management succession plans that work towards ensuring that executive officer and key management positions can be appropriately filled as vacancies occur. The Company has taken similar steps in key technical and craft areas.

Avista Energy focuses on optimization of combustion turbines and hydroelectric assets owned by other entities, long-term electric supply contracts, natural gas storage, and electric transmission and natural gas transportation arrangements. Avista Energy is also involved in trading electricity and natural gas, including derivative commodity instruments. Avista Energy Canada, Ltd. (Avista Energy Canada) is a wholly owned subsidiary of Avista Energy that provides natural gas services to approximately 250 industrial and commercial customers that represent over 400 sites in British Columbia, Canada. In addition to earnings and resulting cash flows from settled or realized

transactions, Avista Energy records unrealized or mark-to-market adjustments for the change in the value of derivative commodity instruments. Avista Energy's marketing, trading and resource management activities are driven by its base of knowledge and experience in the operation of both electric energy and natural gas physical systems in the WECC, as well as its relationship-focused approach with its customers.

Avista Energy is subject to certain regulatory proceedings that remain unresolved; however, Avista Energy believes that it has adequate reserves established for refunds that may be ordered. The wholesale power markets in which Avista Energy operates continue to change with respect to market participants involved, level of activity, volatility in market prices, liquidity, regulatory imposed price caps and counterparty credit issues.

Net income for Avista Energy and the Energy Marketing Resource Management segment decreased for 2004 as compared to 2003. This was primarily due to the positive effects in 2003 of accounting for energy trading activities under Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities" and the settlement of positions with certain Enron Corporation (Enron) affiliates. Both 2004 and 2003 net income for the Energy Marketing and Resource Management segment were decreased by impairment charges for a turbine and related equipment owned by Avista Power. The Company does not expect these factors to occur in 2005.

Avista Advantage remains focused on increasing revenues, controlling operating expenses, continuously enhancing client satisfaction and developing complementary value-added services. The Company expects that net income for Avista Advantage for 2005 will increase as compared to 2004 based on improving revenues and stabilized operating expenses from processing efficiencies.

Over time as opportunities arise, the Company plans to continue to dispose of assets and phase out operations in the Other business segment. The Company expects the net loss in the Other business segment to be less for fiscal year 2005 as compared to 2004 due to decreased losses from asset impairments and write-offs.

During 2005, the Company expects cash flows from operations and Avista Corp.'s five-year \$350.0 million committed line of credit to provide adequate resources to fund capital expenditures, maturing long-term debt (excluding \$54.6 million of maturing WP Funding LP debt) and other contractual commitments. However, if market conditions warrant such actions, the Company may issue securities to fund these obligations, refinance existing debt and repurchase long-term debt scheduled to mature in future years to reduce its overall debt service costs, as well as to manage the risk associated with future changes in interest rates on debt maturities scheduled for 2007 and 2008.

Avista Utilities – Electric Resources

As of December 31, 2004, Avista Utilities' facilities had a total net capability of approximately 1,663 MW, of which 59 percent was hydroelectric and 41 percent was thermal. The addition of the remaining interest in Coyote Springs 2 changes Avista Utilities net capability mix to 54 percent hydroelectric and 46 percent thermal. In addition to company owned resources, Avista Utilities has a number of long-term power purchase and exchange contracts that increase its available resources. See "Note 7 of the Notes to Consolidated Financial Statements" for information with respect to Avista Utilities' resource optimization process.

Avista Utilities – Regulatory Matters

General Rate Cases

Avista Utilities regularly reviews the need for electric and natural gas rate changes in each state in which it provides service. Avista Utilities plans to file an electric general rate case in Washington during March or April of 2005.

In January 2005, the Washington Utilities and Transportation Commission (WUTC) issued its final order with respect to a natural gas general rate case filed by Avista Utilities in Washington. The final order authorized, among other things, an increase in natural gas rates of 3.9 percent, which is designed to increase annual revenues by \$5.4 million. The final order authorized an overall rate of return of 8.68 percent. The natural gas rate increase was implemented in November 2004 resulting from a settlement agreement reached among the Company, the staff of the WUTC and the Northwest Industrial Gas Users in October 2004. The increase was approved by the WUTC in November 2004 on a "subject to refund" basis to allow the non-settling parties the opportunity to further review the case.

In October 2004, the Idaho Public Utilities Commission (IPUC) issued its final order with respect to electric and natural gas general rate cases filed by Avista Utilities in Idaho. The final order authorized, among other things,

Avista Utilities to increase its electric base rates by 16.9 percent, which is designed to increase annual revenues by \$24.7 million, and increase its natural gas base rates by 6.4 percent, which is designed to increase annual revenues by \$3.3 million. Due to a decrease implemented concurrently in Avista Utilities' power cost adjustment (PCA) surcharge and certain other minor adjustments, the net increase in electric rates for Idaho customers was 1.9 percent above rates in effect at that time. The decrease in the PCA surcharge reduces the rate increase impact to customers and extends the period for recovery of deferred power costs. The final order authorized an overall rate of return of 9.25 percent and a return on common equity of 10.4 percent based on an authorized equity level of approximately 43 percent. The final order required Avista Utilities to write off a total of \$14.4 million. The write-off included the disallowance of \$12.0 million of certain deferred power costs, including associated interest, related to natural gas contracts entered into by Avista Utilities to provide fuel for its generating facilities and the disallowance of \$2.4 million (net of \$0.3 million of accumulated depreciation) of certain capitalized utility plant costs. Avista Utilities believes that such costs were prudently incurred and reasonable given the market conditions at the time. Avista Utilities filed a petition for reconsideration of certain portions of the final order including the disallowance of \$4.8 million of certain deferred power costs and \$2.6 million of certain utility plant costs. In November 2004, the IPUC denied the petition for reconsideration with the exception of certain minor technical corrections, which reduced the total write-off by \$0.3 million. As such, the matter is closed.

In September 2003, the Oregon Public Utility Commission (OPUC) approved a natural gas general rate increase for Oregon customers, which was designed to increase annual revenues by \$6.3 million effective October 1, 2003. The order authorized, among other things, an overall rate of return of 8.88 percent and a return on equity of 10.25 percent based on an authorized equity level of approximately 48 percent.

Other Regulatory Filings

In January 2005, Avista Utilities filed a request with the IPUC to include the acquisition of the remaining 50 percent of Coyote Springs 2 in base electric rates. Avista Utilities requested a 1.9 percent increase in base electric rates, which is designed to increase annual revenues by \$3.2 million. At the same time, Avista Utilities requested that the IPUC approve a 1.9 percent reduction in the company's current PCA rate surcharge. These two requests together would result in no overall change to customers' existing rates. On March 1, 2005, the IPUC Staff filed comments in support of Avista Utilities' request and one other party filed comments opposing Avista Utilities' request. Avista Utilities plans to file reply comments by March 15, 2005. In Washington, the acquisition of Coyote Springs 2 will be addressed in the expected general rate case filing.

Avista Utilities is also involved in regulatory proceedings before the California Public Utilities Commission (CPUC) with respect to the sale of its South Lake Tahoe, California natural gas distribution properties. See "Note 27 of the Notes to Consolidated Financial Statements."

Power Cost Deferrals and Recovery Mechanisms

Avista Utilities defers the recognition in the income statement of certain power supply costs that are in excess of the level currently recovered from retail customers as authorized by the WUTC and the IPUC. A portion of power supply costs are recorded as a deferred charge on the Consolidated Balance Sheets for future review and the opportunity for recovery through retail rates.

In Washington, the Energy Recovery Mechanism (ERM) allows Avista Utilities to increase or decrease electric rates periodically with WUTC approval to reflect changes in power supply costs. The ERM provides for Avista Utilities to incur the cost of, or receive the benefit from, the first \$9.0 million in annual power supply costs above or below the amount included in base retail rates. Under the ERM, 90 percent of the power supply costs exceeding or below the initial \$9.0 million are deferred for future surcharge or rebate to Avista Utilities' customers. The remaining 10 percent of power supply costs are an expense of, or benefit to, the Company. The Company expensed the initial \$9.0 million of power supply costs above the amount included in base retail rates during 2004, 2003 and 2002 (\$4.5 million due to mid-year implementation on July 1, 2002) and expects to expense the initial \$9.0 million during 2005.

Under the ERM, Avista Utilities agreed to make an annual filing on or before April 1st of each year to provide the opportunity for the WUTC and other interested parties to review the prudence of and audit the ERM deferred power cost transactions for the prior calendar year. The ERM provides for a 90-day review period for the filing; however, the period may be extended by agreement of the parties or by WUTC order. In August 2004, the WUTC issued an order, which approved the recovery of \$22.8 million of deferred power costs incurred in 2003. On or before December 31, 2006, Avista Utilities will make a filing with the WUTC that will allow interested parties the opportunity to review and propose changes to the ERM.

Avista Utilities has a PCA mechanism in Idaho that allows it to modify electric rates periodically with IPUC approval. Under the PCA mechanism, Avista Utilities defers 90 percent of the difference between certain actual net power supply expenses and the authorized level of net power supply expense approved in the last Idaho general rate case. As disclosed at "General Rate Cases" above, the IPUC issued its final order with respect to general electric and natural gas rate cases filed by Avista Utilities in Idaho. The final order required Avista Utilities to write off a total of \$12.0 million of certain deferred power costs, including associated interest, related to natural gas contracts entered into by Avista Utilities to provide fuel for its generating facilities. The IPUC authorized the recovery of the remaining deferred power costs over a two-year period through a PCA rate surcharge to customers of 4.4 percent. See "Other Regulatory Filings" with respect to Avista Utilities' request to decrease the PCA rate surcharge.

The following table shows activity in deferred power costs for Washington and Idaho during 2003 and 2004 (dollars in thousands):

	Washington	Idaho	Total
Deferred power costs as of December 31, 2002.....	\$123,749	\$31,518	\$155,267
Activity from January 1 – December 31, 2003:			
Power costs deferred.....	22,217	23,341	45,558
Unrealized loss on fuel contracts (1)	1,975	1,004	2,979
Interest and other net additions.....	6,002	1,037	7,039
Write-off of deferred power costs.....	(2,461)	-	(2,461)
Recovery of deferred power costs through retail rates.....	<u>(25,777)</u>	<u>(26,615)</u>	<u>(52,392)</u>
Deferred power costs as of December 31, 2003.....	125,705	30,285	155,990
Activity from January 1 – December 31, 2004:			
Power costs deferred.....	10,498	15,276	25,774
Unrealized gain on fuel contracts (1).....	(3,139)	(1,596)	(4,735)
Interest and other net additions.....	6,354	532	6,886
Write-off of deferred power costs.....	-	(11,959)	(11,959)
Recovery of deferred power costs through retail rates.....	<u>(26,210)</u>	<u>(23,040)</u>	<u>(49,250)</u>
Deferred power costs as of December 31, 2004.....	<u>\$113,208</u>	<u>\$9,498</u>	<u>\$122,706</u>

(1) Unrealized gains and losses on fuel contracts are not included in the ERM and PCA mechanism until the contracts are settled or realized.

Purchased Gas Adjustments

During recent years, natural gas prices have been volatile with a general upward trend. Avista Utilities' average prices per dekatherm were \$6.62, \$5.50 and \$4.95 in 2004, 2003 and 2002, respectively. The continued upward price trend has caused the recovery period for deferred natural gas costs to lengthen. The Company is connected to multiple supply basins in the western United States and western Canada and believes there will be sufficient supplies of natural gas to meet its customers' needs. However, natural gas prices in the Pacific Northwest are increasingly affected by supply and demand factors in other regions of the United States and Canada because of growth in transcontinental pipeline capacity. Global energy markets also affect natural gas prices. Natural gas commodity costs in excess of, or which fall below, the amount recovered in current retail rates are deferred and recovered or refunded as a pass-through to customers in future periods with applicable regulatory approval through adjustments to rates.

During September and October of 2003, natural gas rate increases of 8.7 percent, 2.4 percent, 12.4 percent and 15.0 percent were approved and implemented in Washington, Idaho, Oregon and California, respectively. During September through November of 2004, natural gas rate increases of 11.7 percent, 14.2 percent, 12.6 percent and 10.5 percent were approved and implemented in Washington, Idaho, Oregon and California, respectively. These natural gas rate increases are designed to pass through changes in purchased natural gas costs to customers with no change in Avista Utilities' gross margin or net income. Total deferred natural gas costs were \$28.6 million and \$15.4 million as of December 31, 2004 and 2003, respectively.

Natural Gas Benchmark Mechanism

The IPUC, WUTC and OPUC approved Avista Utilities' Natural Gas Benchmark Mechanism in 1999. The mechanism eliminated the majority of natural gas procurement operations within Avista Utilities and placed responsibility for natural gas procurement operations with Avista Energy, the Company's non-regulated subsidiary. The ownership of the natural gas assets remains with Avista Utilities; however, the assets have been managed by Avista Energy through an Agency Agreement. In early 2002, the IPUC and the OPUC approved the continuation of the Natural Gas Benchmark Mechanism and related Agency Agreement through March 31, 2005. In February 2004,

the WUTC ordered that the Natural Gas Benchmark Mechanism and related Agency Agreement be terminated for Washington customers and ordered Avista Utilities to file a transition plan to move management of these functions back into Avista Utilities. In April 2004, the WUTC approved Avista Utilities' transition plan, which provides for the movement of these functions back into Avista Utilities to be completed by March 31, 2005. Effective April 1, 2005, the Company will also be moving these functions from Avista Energy to Avista Utilities for Idaho and Oregon natural gas customers with the expiration of the current agreements. As part of the transition plan, Avista Utilities has begun procuring natural gas for load service. This procurement process includes entering into financial and physical hedging transactions as a means of managing risks. This transition of Avista Utilities' natural gas procurement operations also impacts the level of counterparty credit requirements at both Avista Utilities and Avista Energy. In response to this as well as to provide enhanced financial flexibility, in May 2004 Avista Corp. increased the amount available under its committed line of credit to \$350.0 million from \$245.0 million. In December 2004, Avista Corp. entered into a five-year \$350.0 million committed line of credit, which replaced the 364-day committed line of credit entered into in May 2004.

Power Market Issues

Legal and Regulatory Proceedings in Western Power Markets

Avista Energy and Avista Utilities are involved in a number of legal and regulatory proceedings and complaints with respect to power markets in the western United States. Most of these proceedings and complaints relate to the significant increase in the spot market price of energy in western power markets in 2000 and 2001, which allegedly contributed to or caused unjust and unreasonable prices and allegedly may have been the result of manipulations by certain other parties. These proceedings and complaints include, but are not limited to, refund proceedings and hearings in California and the Pacific Northwest, market conduct investigations by the FERC (including a specific investigation of Avista Utilities and Avista Energy), and complaints and cross-complaints filed by various parties with respect to alleged misconduct by other parties in western power markets. As a result of these proceedings and complaints, certain parties have asserted claims for significant refunds and damages from Avista Energy and Avista Utilities, which could result in a negative impact on future earnings. Avista Energy and Avista Utilities have joined other parties in opposing these refund claims and complaints for damages. See further information under "Federal Energy Regulatory Commission Inquiry," "Counterparty Defaults," "California Refund Proceeding," "Pacific Northwest Refund Proceeding," "Reliant Energy, Inc. and Duke Energy Corporation Cross-Complaints," "California Attorney General Complaint," "Port of Seattle Complaint," "Wah Chang Complaint," "City of Tacoma Complaint," and "State of Montana Proceedings" in "Note 25 of the Notes to Consolidated Financial Statements."

Market Conduct Investigations and Market-Based Rate Authority

As a result of certain revelations about alleged improper practices engaged in by Enron and certain of its affiliates, the FERC initiated investigations in February 2002 of Avista Corp. doing business as Avista Utilities, Avista Energy and other unrelated parties. Avista Utilities and Avista Energy cooperated with the FERC investigation by providing requested documents and other information. Several parties filed documents with the FERC in March 2003 alleging improper market conduct by various parties, including Avista Utilities and Avista Energy, and requesting refunds and other relief. Avista Utilities and Avista Energy filed replies in response to the allegations of the parties.

In March 2003, the FERC policy staff issued its final report on its investigation of western energy markets. In the report, the FERC policy staff recommended the issuance of "show cause" orders to dozens of companies to respond to allegations of possible misconduct in the western energy markets during 2000 and 2001. Of the companies named in the March 2003 FERC policy staff report, Avista Corp. and Avista Energy were among the few that had already been subjects of a FERC investigation. See further information under "Federal Energy Regulatory Commission Inquiry" in "Note 25 of the Notes to Consolidated Financial Statements."

Every three years or more frequently if certain regulatory triggers are met, Avista Corp. doing business as Avista Utilities, and Avista Energy are required to file for renewal of their respective market-based rate authority with the FERC. Avista Utilities and Avista Energy made their respective filings with the FERC on September 27, 2004. The filing was amended, at the request of the FERC Staff, with additional information on December 7, 2004 and February 4, 2005. No comments or interventions were filed by interested parties by the close of the comment period on February 14, 2005. By order issued on March 3, 2005, the FERC approved the renewal of the market-based rate authority of Avista Utilities and Avista Energy.

Wholesale Energy Markets and Development of Regional Transmission Organizations

The FERC has proposed changes to the design of the wholesale energy market, which includes the formation of Regional Transmission Organizations. This could significantly change how transmission facilities are regulated and operated.

AVISTA CORPORATION

Avista Corp. has participated with other utilities in the western United States on the possible formation of a Regional Transmission Organization. Interim bylaws governing continuing developmental activities for this non-profit corporation, under the name Grid West, were adopted on December 9, 2004. The next phase of the development of Grid West would be the establishment of a board of directors, which is currently planned for late-2005.

The final proposal for any Regional Transmission Organization must be filed with the FERC and approved by the boards of directors of the filing companies and regulators in various states. The Company's decision to move forward with the formation of any Regional Transmission Organization serving the Pacific Northwest region, as well as the legal, financial and operating implications of such decisions, will ultimately depend on the terms and conditions related to the formation of the entities and conditions established in the regulatory approval processes. The Company cannot predict these implications.

Results of Operations

Diluted Earnings (Loss) per Common Share by Business Segments

The following table presents diluted earnings (loss) per common share by business segments for the years ended December 31:

	2004	2003	2002
Avista Utilities.....	\$0.67	\$0.72	\$0.71
Energy Marketing and Resource Management.....	0.20	0.43	0.47
Avista Advantage	0.01	(0.03)	(0.09)
Other.....	<u>(0.15)</u>	<u>(0.10)</u>	<u>(0.26)</u>
Earnings per common share from continuing operations.....	0.73	1.02	0.83
Loss per common share from discontinued operations.....	-	<u>(0.10)</u>	<u>(0.14)</u>
Earnings per common share before cumulative effect of accounting change.....	0.73	0.92	0.69
Loss per common share from cumulative effect of accounting change	<u>(0.01)</u>	<u>(0.03)</u>	<u>(0.09)</u>
Total earnings per common share, diluted	<u>\$0.72</u>	<u>\$0.89</u>	<u>\$0.60</u>

Overall Operations

2004 compared to 2003

Income from continuing operations was \$35.6 million for 2004 compared to \$50.6 million for 2003. This decrease was primarily due to the Idaho general rate case write-offs of \$14.4 million (\$9.4 million, net of tax) recorded at Avista Utilities, as well as reduced earnings for Avista Energy (Energy Marketing and Resource Management segment) and an increase in the net loss for the Other business segment. This was partially offset by the improved performance of Avista Utilities (excluding the Idaho write-offs) due to general rate increases, as well as net earnings from Avista Advantage for 2004 as compared to a net loss for 2003.

Net income for Energy Marketing and Resource Management was \$9.7 million for 2004 compared to \$20.7 million (excluding the cumulative effect of accounting change) for 2003. During 2003, Avista Energy's earnings were positively impacted by the effects of accounting for energy contracts under SFAS No. 133 and a settlement with certain Enron affiliates. In addition, Avista Energy's earnings were decreased due to lower natural gas trading margins in 2004 as compared to 2003. These decreases were partially offset by portfolio valuation adjustments at Avista Energy of approximately \$2.9 million, net of tax, the most significant of which relates to increases in market liquidity in the Western power markets. Both 2004 and 2003 net income for the Energy Marketing and Resource Management segment were decreased by impairment charges for a turbine and related equipment owned by Avista Power, which is classified as held for sale.

Net income for Avista Utilities was \$32.5 million for 2004, compared to \$36.2 million for 2003. The decrease for Avista Utilities was primarily due to the Idaho general rate case write-offs. Excluding the write-offs, net income increased primarily due to an increase in gross margin as a result of general rate increases, partially offset by an increase in other operating expenses (operations and maintenance, administrative and general, depreciation and amortization, and taxes other than income taxes).

Avista Advantage had net income of \$0.6 million for 2004 compared to a net loss of \$1.3 million for 2003. The change was primarily due to an increase in operating revenues, partially offset by the settlement of an employment contract.

The Other business segment incurred a net loss of \$7.2 million (excluding the cumulative effect of accounting change) for 2004 compared to a net loss of \$4.9 million for 2003. The increase in the net loss was primarily due to the impairment of goodwill at AM&D, the write-off of an investment in a natural gas storage project, the accrual of an environmental liability at Avista Development and Avista Capital's purchase of Avista Advantage preferred stock at a premium. This was partially offset by a reduced net loss from AM&D, excluding the goodwill impairment.

Total revenues increased \$28.2 million for 2004 compared to 2003. Avista Utilities' revenues increased \$44.4 million due to increases in both electric and natural gas revenues. The increase in natural gas revenues was primarily due to natural gas rate increases implemented during 2004 and 2003 and partially due to increased therms sold, primarily as a result of customer growth. The increase in electric revenues reflects an increase in retail revenues, partially offset by a decrease in wholesale revenues and sales of fuel. Revenues from Energy Marketing and Resource Management decreased \$31.5 million primarily due to decreased net trading margin on contracts accounted for under SFAS No. 133, a settlement with Enron affiliates during 2003 and decreased revenues under the Agency Agreement with Avista Utilities, partially offset by increased revenues for Avista Energy Canada. Revenues from Avista Advantage increased \$3.6 million to \$23.4 million primarily as a result of customer growth. Revenues from the Other business segment increased \$3.5 million to \$17.1 million primarily due to increased revenues from AM&D as well as revenues from entities consolidated in 2004 under Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities," which was revised in December 2003 (collectively referred to as FIN 46).

Total resource costs increased \$28.5 million for 2004 compared to 2003. Resource costs for Avista Utilities increased \$30.5 million primarily due to an increase in purchased natural gas costs as well as the write-off of \$12.0 million of deferred power costs resulting from the Idaho general rate case order. This increase in purchased natural gas costs was primarily due to an increase in prices and partially due to an increase in the volume purchased due to customer growth. Resource costs for Energy Marketing and Resource Management decreased \$10.1 million primarily due to decreased resource costs for Avista Energy Canada and decreased resource costs under the Agency Agreement with Avista Utilities.

Intersegment eliminations, which decrease both operating revenues and resource costs, were \$137.2 million for 2004 compared to \$145.4 million for 2003, representing decreased purchases of natural gas under the Agency Agreement between Avista Utilities and Avista Energy.

Operations and maintenance expenses increased \$17.9 million for 2004 compared to 2003 partially due to the disallowance in the Idaho general rate case of \$2.4 million (net of \$0.3 million of accumulated depreciation) of certain capitalized utility plant costs at Avista Utilities. The remaining increase for Avista Utilities was primarily due to a general increase in operations and maintenance expense primarily related to distribution and customer service expenses, partially reflecting an increase in labor costs. Operations and maintenance expense for the Other business segment increased \$2.6 million due to the write-off of an investment in a natural gas storage project as well as the effects from entities consolidated under FIN 46.

Administrative and general expenses increased \$6.8 million for 2004 compared to 2003 primarily due to increased expenses for Avista Utilities, Avista Advantage and the Other business segment, partially offset by decreased expenses for Energy Marketing and Resource Management. The decrease for Energy Marketing and Resource Management was primarily a result of decreased compensation expenses and professional fees. The increase for Avista Utilities primarily reflects an increase in labor costs and other employee related expenses, increased liability and damage claims insurance costs, as well as an increase in outside services. The increase for Avista Advantage was primarily due to the settlement of an employment contract. The increase for the Other business segment primarily reflects the impairment of goodwill at AM&D and the accrual of an environmental liability at Avista Development.

Depreciation and amortization increased \$0.6 million for 2004 compared to 2003 primarily due to utility plant additions at Avista Utilities and the resulting increase in depreciation expense as well as the consolidation of WP Funding LP under FIN 46 and the resulting inclusion of depreciation expense of the Rathdrum Power Plant. This was partially offset by a correction at Avista Utilities for overstated depreciation expense in prior periods recorded during 2004. Coyote Springs 2 was placed into service in mid-2003 and increased depreciation expense for 2004 as compared to 2003.

Taxes other than income taxes increased \$5.7 million for 2004 compared to 2003 primarily due to increased retail revenues and related taxes for Avista Utilities. An increase in property taxes at Avista Utilities also contributed to the increase in taxes other than income taxes.

Interest expense (including interest expense to affiliated trusts) increased \$0.1 million for 2004 compared to 2003 primarily due to the inclusion of the interest expense on \$54.6 million of debt of WP Funding LP, which was consolidated for all of 2004 and only the fourth quarter of 2003 as required by FIN 46, as well as an increase in interest on short-term borrowings and the inclusion of preferred stock dividends as interest expense in accordance with SFAS No. 150, partially offset by a decrease in interest expense on long-term debt due to the repurchase of higher cost debt. Preferred stock dividends of \$1.1 million, distributed prior to the adoption of SFAS No. 150 on July 1, 2003, were classified as a separate line item in the Consolidated Statement of Income for 2003.

Capitalized interest increased \$0.3 million for 2004 compared to 2003. This was primarily due to increased construction activity at Avista Utilities and higher average construction work in progress balances.

Other income-net increased \$2.2 million for 2004 compared to 2003 primarily due to increased income in 2004 on certain investments in the Other business segment and net gains on the disposition of non-operating assets in 2004 compared to net losses in 2003. This was partially offset by the premium paid on the repurchase of Avista Advantage preferred stock, as well as a decrease in interest income and interest on power and natural gas deferrals.

Income taxes decreased \$13.7 million for 2004 compared to 2003, primarily due to decreased income before income taxes. The effective tax rate was 37.7 percent for 2004 compared to 41.1 percent for 2003.

During 2004, the Other business segment recorded as a cumulative effect of accounting change a charge of \$0.5 million related to the implementation of FIN 46, which required Avista Ventures to consolidate several minor entities.

During 2003, Avista Energy recorded as a cumulative effect of accounting change a charge of \$1.2 million (net of tax) related to Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which effectively required the transition of accounting for energy trading activities from EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" to SFAS No. 133.

2003 compared to 2002

Income from continuing operations was \$50.6 million for 2003 compared to \$42.2 million for 2002. The increase was primarily due to a decrease in the net losses for Avista Advantage and the Other business segment, partially offset by decreased net income for Energy Marketing and Resource Management.

Net income for Energy Marketing and Resource Management was \$20.7 million (excluding the cumulative effect of accounting change) for 2003 compared to \$22.4 million for 2002. This decrease was primarily due to a \$3.2 million (net of tax) impairment charge recorded by Avista Power, partially offset by an increase in gross margin for Avista Energy. During 2003, Avista Energy's earnings were positively impacted by the effects of accounting for energy contracts under SFAS No. 133 and a settlement with certain Enron affiliates. Avista Energy's transition to SFAS No. 133 resulted in contracts, which are not considered derivatives, no longer being accounted for at market value. The transition to SFAS No. 133 increased the volatility of reported earnings due to the fact that certain contracts, which are not considered derivatives, are economically hedged by contracts that are accounted for as derivative instruments at market value under SFAS No. 133.

Net income for Avista Utilities was \$36.2 million for 2003, compared to \$36.4 million for 2002. The decrease for Avista Utilities was primarily due to an increase in other operating expenses (operations and maintenance, administrative and general, and depreciation and amortization), partially offset by an increase in gross margin and a decrease in interest expense.

Avista Advantage incurred a net loss of \$1.3 million for 2003 compared to \$4.3 million for 2002. The decrease in the net loss was primarily due to an increase in operating revenues and a decrease in operating expenses.

The Other business segment incurred a net loss of \$4.9 million for 2003 compared to \$12.4 million (excluding the cumulative effect of accounting change) for 2002. The decrease in the net loss was primarily due to a reduction in litigation costs and settlements.

Total revenues increased \$60.5 million for 2003 compared to 2002. Avista Utilities' revenues increased \$34.2 million primarily due to increased electric revenues, partially offset by decreased natural gas revenues. The decrease in natural gas revenues was primarily due to natural gas rate decreases implemented during the fourth quarter of

2002 and partially due to decreased therms sold as a result of warmer weather during the first quarter of 2003 as compared to the first quarter of 2002. Natural gas rate increases were implemented in September and October 2003 in response to increased natural gas costs. The increase in electric revenues reflects an increase in retail revenues, wholesale revenues and sales of fuel. Revenues from Energy Marketing and Resource Management increased \$84.5 million primarily due to increased revenues on contracts that are not considered derivatives under SFAS No. 133 (primarily the Agency Agreement with Avista Utilities), non-trading derivative contracts and revenues from Avista Energy Canada. Avista Energy's settlement of various positions with Enron affiliates and the resulting release by Avista Energy of amounts, which had been reserved against such positions, also had a positive impact of \$8.4 million on operating revenues for 2003. Revenues from Avista Advantage increased 17 percent to \$19.8 million primarily as a result of customer growth. Revenues from the Other business segment decreased \$1.1 million primarily due to decreased revenues from AM&D.

Total resource costs increased \$39.8 million for 2003 compared to 2002. Resource costs for Avista Utilities increased \$21.4 million primarily due to an increase in the expense for power purchased, natural gas purchased, fuel for generation and other fuel costs, partially offset by a decrease in the net amortization of deferred power and natural gas costs. The increase in power purchased expense and natural gas purchased was primarily due to an increase in prices. Resource costs for Energy Marketing and Resource Management increased \$78.5 million due to an increase in costs from contracts that are not accounted for as derivatives under SFAS No. 133 (primarily the Agency Agreement with Avista Utilities), non-trading derivative contracts and resource costs of Avista Energy Canada, partially offset by a change in natural gas inventory valuations.

Intersegment eliminations, which decreases both operating revenues and resource costs were \$145.4 million for 2003 compared to \$85.2 million for 2002, representing increased purchases of natural gas under the Agency Agreement between Avista Utilities and Avista Energy.

Operations and maintenance expenses increased \$12.1 million for 2003 compared to 2002 primarily due to increased expenses for Avista Utilities and the \$4.9 million impairment of a turbine at Avista Power (Energy Marketing and Resource Management segment), partially offset by decreased expenses for Avista Advantage and the Other business segment. The increase in operations and maintenance expenses for Avista Utilities was partially due to increased pension costs, and expenses for Coyote Springs 2, which commenced operations in mid-2003. The increase for Avista Utilities was also due to initiatives implemented during the third quarter of 2001 designed to temporarily reduce certain operating expenses to improve liquidity and operating cash flows. These initiatives resulted in significantly reduced expenses for 2001 and the first half of 2002.

Administrative and general expenses decreased \$8.2 million for 2003 compared to 2002 primarily due to decreased expenses for the Other business segment, partially offset by increased expenses for Avista Utilities and Energy Marketing and Resource Management. Administrative and general expenses for the Other business segment decreased due to reduced litigation costs and settlements. The increase for Energy Marketing and Resource Management was primarily a result of increased compensation expenses. The increase for Avista Utilities was consistent with the increase in operations and maintenance expenses. Increased insurance costs also contributed to the increase in administrative and general expenses for Avista Utilities.

Depreciation and amortization increased \$5.9 million for 2003 compared to 2002 primarily due to utility plant additions at Avista Utilities and the resulting increase in depreciation expense. Coyote Springs 2 was placed into service in mid-2003, which increased depreciation expense by \$2.2 million.

Taxes other than income taxes decreased \$3.8 million for 2003 compared to 2002 primarily due to decreased retail natural gas revenues and related taxes for Avista Utilities.

Interest expense decreased \$11.9 million for 2003 compared to 2002 primarily due to a decrease in the average balance of debt outstanding. This decrease was partially offset by the inclusion of \$1.1 million of preferred stock dividends as interest expense for the second half of 2003 in accordance with SFAS No. 150. During 2003 and 2002, the Company repurchased \$52.5 million and \$203.6 million of long-term debt, respectively. In September 2003, the Company issued \$45.0 million of 6.125 percent First Mortgage Bonds due in 2013. The proceeds were used to repay a portion of the borrowings under the then existing \$245.0 million line of credit that was used on an interim basis to fund \$46.0 million of maturing 9.125 percent Unsecured Medium-Term Notes.

Capitalized interest decreased \$6.4 million for 2003 compared to 2002. This was primarily due to the fact that the Company did not capitalize any interest related to Coyote Springs 2 subsequent to September 30, 2002 because the project was substantially completed.

Other income-net decreased \$11.1 million for 2003 compared to 2002 primarily due to reduced interest income (including accrued interest on power and natural gas deferrals) as well as losses in 2003 on certain investments in the Other business segment. The decrease in interest income primarily reflects the repayment of a note receivable in the Other business segment in the fourth quarter of 2002 and decreased earnings on short-term investments.

Income taxes increased \$0.5 million for 2003 compared to 2002. The effective tax rate was 41.1 percent for 2003 compared to 45.2 percent for 2002.

During 2003, Avista Energy recorded as a cumulative effect of accounting change a charge of \$1.2 million (net of tax) related to EITF Issue No. 02-3, which effectively required the transition of accounting for energy trading activities from EITF Issue No. 98-10 to SFAS No. 133. EITF Issue No. 02-3 rescinded EITF Issue No. 98-10 and related interpretative guidance. Under EITF Issue No. 02-3, mark-to-market accounting is precluded for energy trading contracts that are not derivatives pursuant to SFAS No. 133. The rescission of EITF Issue No. 98-10 also eliminated the recognition of physical inventories at fair value other than those provided for in other accounting standards.

In April 2002, the Company completed its transitional test of goodwill related to the adoption of SFAS No. 142 "Goodwill and Other Intangible Assets." Accordingly, the Company determined that \$4.1 million (net of tax) of goodwill related to AM&D was impaired and recorded this as a cumulative effect of accounting change for 2002.

Avista Utilities

2004 compared to 2003

Net income for Avista Utilities was \$32.5 million for 2004 compared to \$36.2 million for 2003. Avista Utilities' income from operations was \$134.1 million for 2004 compared to \$146.8 million for 2003. This decrease was primarily due to the Idaho general rate case write-offs of \$14.4 million (\$9.4 million, net of tax).

The following table presents Avista Utilities' gross margin for the years ended December 31 (dollars in thousands):

	Electric		Natural Gas		Total	
	2004	2003	2004	2003	2004	2003
Operating revenues.....	\$652,081	\$650,922	\$320,493	\$277,289	\$972,574	\$928,211
Resource costs.....	<u>291,388</u>	<u>294,031</u>	<u>214,003</u>	<u>180,896</u>	<u>505,391</u>	<u>474,927</u>
Gross margin.....	<u>\$360,693</u>	<u>\$356,891</u>	<u>\$106,490</u>	<u>\$ 96,393</u>	<u>\$467,183</u>	<u>\$453,284</u>

Avista Utilities' operating revenues increased \$44.4 million and resource costs increased \$30.5 million, which resulted in an increase of \$13.9 million in gross margin for 2004 as compared to 2003. The gross margin on natural gas sales increased \$10.1 million and the gross margin on electric sales increased \$3.8 million. The increase in the gross margin on natural gas sales was primarily due to the Idaho natural gas general rate increase implemented in September 2004, the Washington natural gas general rate increase implemented in November 2004 and the Oregon natural gas general rate increase implemented in the fourth quarter of 2003. The increase in electric gross margin was primarily due to the Idaho electric general rate increase implemented in September 2004 as well as customer growth. This was partially offset by the disallowance of \$12.0 million of deferred power costs in the Idaho general rate case.

The following table presents Avista Utilities' electric operating revenues and megawatt-hour (MWh) sales for the years ended December 31 (dollars and MWhs in thousands):

	Electric Operating Revenues		Electric Energy MWh sales	
	2004	2003	2004	2003
Residential.....	\$209,518	\$204,783	3,343	3,298
Commercial.....	201,775	201,339	2,919	2,919
Industrial.....	90,288	78,276	2,076	1,785
Public street and highway lighting.....	<u>4,847</u>	<u>4,770</u>	<u>25</u>	<u>25</u>
Total retail.....	506,428	489,168	8,363	8,027
Wholesale.....	62,399	73,463	1,472	2,075
Sales of fuel.....	63,990	71,456	-	-
Other.....	<u>19,264</u>	<u>16,835</u>	-	-
Total.....	<u>\$652,081</u>	<u>\$650,922</u>	<u>9,835</u>	<u>10,102</u>

Retail electric revenues increased \$17.3 million for 2004 from 2003. This increase was primarily due to an increase in total MWhs sold (increased revenues \$20.4 million), partially offset by a decrease in revenue per MWh (decreased revenues \$3.1 million). Although there were differences with respect to quarter-to-quarter comparisons, total heating and cooling degree days at Spokane, Washington for both 2004 and 2003 were similar with both warmer than normal heating and cooling seasons. As such, electric loads and revenues were not significantly affected by weather when comparing 2004 to 2003 results. The increase in total MWhs sold and corresponding revenues was primarily due to customer growth as well as the Potlatch Corporation contract, which was entered into during mid-2003. The decrease in revenue per MWh was primarily due to a slight change in revenue mix with a greater percentage of revenues from industrial sales. The increase in industrial revenues was primarily due to the Potlatch Corporation contract. In September 2004, a general electric rate increase was implemented in Idaho. However, this was almost entirely offset by a decrease in the PCA surcharge, such that the net increase in rates to Idaho customers was only 1.9 percent. Although the general rate case increased gross margin, income from operations and net income, it did not have a significant effect on operating revenues for 2004 as compared to 2003.

Wholesale electric revenues decreased \$11.1 million primarily due to the implementation of EITF Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not Held for Trading Purposes as Defined in EITF Issue No. 02-3" which requires that wholesale revenues and resource costs from Avista Utilities' settled energy contracts that are "booked out" (not physically delivered) should be reported on a net basis as part of operating revenues effective October 1, 2003. The adoption of this EITF Issue resulted in a reduction in wholesale revenues of approximately \$26.4 million for 2004 as compared to 2003. The remaining change in wholesale revenues reflects higher average sales prices and an increase in wholesale sales volumes.

Sales of fuel decreased \$7.5 million as a result of the expiration of several higher priced fuel contracts. A greater percentage of fuel purchases were used in generation, which also contributed to the decrease in sales of fuel. Sales of fuel represents natural gas that was not used for generation because electric wholesale market prices were generally below the cost of operating the natural gas-fired thermal generating units.

Other electric revenues increased \$2.4 million primarily due to increased transmission revenues.

The following table presents Avista Utilities' natural gas operating revenues and therm sales for the years ended December 31 (dollars and therms in thousands):

	Natural Gas Operating Revenues		Natural Gas Therm Sales	
	2004	2003	2004	2003
Residential	\$194,470	\$166,925	201,696	198,471
Commercial	104,754	90,523	122,852	122,115
Industrial	<u>9,423</u>	<u>7,475</u>	<u>13,274</u>	<u>12,737</u>
Total retail	308,647	264,923	337,822	333,323
Wholesale	152	280	305	675
Transportation	8,134	8,485	154,427	153,352
Other	<u>3,560</u>	<u>3,601</u>	<u>3,030</u>	<u>3,124</u>
Total	<u>\$320,493</u>	<u>\$277,289</u>	<u>495,584</u>	<u>490,474</u>

Natural gas revenues increased \$43.2 million for 2004 from 2003 primarily due to an increase in retail natural gas revenues, partially offset by a slight decrease in transportation and wholesale revenues. The \$43.7 million increase in retail natural gas revenues was primarily due to an increase in retail rates (increased revenues \$39.6 million) and partially due to an increase in volumes (increased revenues \$4.1 million). During 2004 and 2003, retail rates for natural gas were increased in response to an increase in current and projected natural gas costs. In September 2004, a general natural gas rate increase was implemented in Idaho. In November 2004, a general natural gas rate increase was implemented in Washington. Also, during the fourth quarter of 2003, a general natural gas rate increase was implemented in Oregon. The increase in total therms sold was primarily a result of customer growth, as a colder first quarter of 2004 was offset by a warmer fourth quarter of 2004 as compared to 2003.

AVISTA CORPORATION

The following table presents Avista Utilities' average number of electric and natural gas customers for the years ended December 31:

	Electric Customers		Natural Gas Customers	
	2004	2003	2004	2003
Residential.....	288,422	283,497	268,571	261,063
Commercial.....	36,728	36,279	31,886	31,312
Industrial.....	1,416	1,414	311	310
Public street and highway lighting.....	418	422	-	-
Total retail.....	326,984	321,612	300,768	292,685
Wholesale.....	43	47	1	1
Transportation.....	-	-	81	84
Total customers.....	<u>327,027</u>	<u>321,659</u>	<u>300,850</u>	<u>292,770</u>

The following table presents Avista Utilities heating and cooling degree days for the years ended December 31:

	2004	2003
Heating degree days (1):		
Spokane, Washington actual.....	6,314	6,351
Spokane, Washington 30 year average (2).....	6,820	6,820
Percentage of average.....	93%	93%
Medford, Oregon actual.....	3,933	4,046
Medford, Oregon 30 year average (2).....	4,592	4,592
Percentage of average.....	86%	88%
Cooling degree days (3):		
Spokane, Washington actual.....	571	578
Spokane, Washington 30 year average (2).....	394	394
Percent of average.....	145%	147%

- (1) Heating degree days are the measure of the coldness of weather experienced, based on the extent to which the average of the high and low temperatures for a day falls below 65 degrees Fahrenheit (annual degree days below historic indicate warmer than average temperatures).
- (2) Computed for the period from 1971 through 2000.
- (3) Cooling degree days are the measure of the warmth of weather experienced, based on the extent to which the average of the high and low temperatures for a day exceeds 65 degrees Fahrenheit (annual degree days above historic indicate warmer than average temperatures).

The following table presents Avista Utilities' resource costs for the years ended December 31 (dollars in thousands):

	2004	2003
Electric resource costs:		
Power purchased.....	\$145,298	\$147,743
Power cost amortizations, net of deferrals.....	22,950	7,165
Fuel for generation.....	38,406	35,581
Other fuel costs.....	72,602	96,765
Other regulatory amortizations, net.....	(10,095)	(7,904)
Other electric resource costs.....	<u>22,227</u>	<u>14,681</u>
Total electric resource costs.....	<u>291,388</u>	<u>294,031</u>
Natural gas resource costs:		
Natural gas purchased.....	225,908	184,014
Natural gas deferrals, net of amortization.....	(12,136)	(3,336)
Other regulatory amortizations, net.....	<u>231</u>	<u>218</u>
Total natural gas resource costs.....	<u>214,003</u>	<u>180,896</u>
Total resource costs.....	<u>\$505,391</u>	<u>\$474,927</u>

Power purchased for 2004 decreased \$2.4 million compared to 2003 due to the effects of EITF Issue No. 03-11 (decreased costs by \$26.4 million), partially offset by an increase in the price of power purchases (increased costs \$15.1 million) and an increase in the volume of power purchases (increased costs \$8.9 million).

Net amortization of deferred power costs was \$23.0 million for 2004 compared to \$7.2 million for 2003. During 2004, Avista Utilities recovered (collected as revenue) \$26.2 million of previously deferred power costs in Washington and \$23.0 million in Idaho. There was a decrease in the recovery of previously deferred power costs in Idaho, which was primarily due to the reduction of the PCA rate surcharge in the Idaho general rate case. During 2004, Avista Utilities deferred \$10.5 million of power costs in Washington and \$15.3 million in Idaho. The total deferral of power costs decreased in 2004 as compared to 2003 due to an increase in hydroelectric generation and the expiration of higher priced natural gas fuel contracts.

Fuel for generation for 2004 increased \$2.8 million compared to 2003 primarily due to an increase in fuel prices and partially due to a slight increase in thermal generation.

Other fuel costs for 2004 decreased \$24.2 million compared to 2003. This natural gas fuel was sold with the associated revenues reflected as sales of fuel. Other fuel costs exceeded the revenues from selling the natural gas. This excess cost is accounted for under the ERM in Washington and the PCA in Idaho. The decrease in other fuel costs was primarily due to the expiration of higher-priced natural gas fuel contracts. The decrease was also due to a greater percentage of fuel used in generation.

Other electric resource costs for 2004 increased \$7.5 million compared to 2003 primarily due to the disallowance of \$12.0 million of deferred power costs in the Idaho general rate case. This was partially offset by the consolidation of WP Funding LP and the elimination of the Rathdrum Power Plant lease expense from resource costs. Costs associated with the Rathdrum Power Plant are primarily reflected as depreciation and interest expense in 2004.

The expense for natural gas purchased for 2004 increased \$41.9 million compared to 2003 due to an increase in the cost of natural gas (increased costs \$37.4 million) and an increase in total therms purchased (increased costs \$4.5 million) consistent with an increase in natural gas sales from customer growth. During 2004, Avista Utilities had \$12.1 million of net deferrals of natural gas costs compared to \$3.3 million for 2003. The increase was primarily due to an increase in natural gas prices.

2003 compared to 2002

Net income for Avista Utilities was \$36.2 million for 2003 compared to \$36.4 million for 2002. Avista Utilities' income from operations was \$146.8 million for 2003 compared to \$149.2 million for 2002. This decrease was primarily due to an increase in operations and maintenance, administrative and general, and depreciation and amortization expenses, partially offset by an increase in gross margin and a decrease in taxes other than income taxes.

The increase in operations and maintenance as well as administrative and general expenses reflects increased pension and insurance costs. The increase was also due to initiatives implemented during the third quarter of 2001 designed to temporarily reduce certain operating expenses to improve liquidity and operating cash flows. These initiatives resulted in significantly reduced expenses for 2001 and the first half of 2002.

The following table presents Avista Utilities' gross margin for the years ended December 31 (dollars in thousands):

	Electric		Natural Gas		Total	
	2003	2002	2003	2002	2003	2002
Operating revenues.....	\$650,922	\$584,141	\$277,289	\$309,823	\$928,211	\$893,964
Resource costs.....	<u>294,031</u>	<u>240,380</u>	<u>180,896</u>	<u>213,145</u>	<u>474,927</u>	<u>453,525</u>
Gross margin.....	<u>\$356,891</u>	<u>\$343,761</u>	<u>\$96,393</u>	<u>\$96,678</u>	<u>\$453,284</u>	<u>\$440,439</u>

Avista Utilities' operating revenues increased \$34.2 million and resource costs increased \$21.4 million, which resulted in an increase of \$12.8 million in gross margin for 2003 as compared to 2002. The gross margin on natural gas sales decreased \$0.3 million and the gross margin on electric sales increased \$13.1 million. The slight decrease in the gross margin on natural gas sales was primarily due to a slight decrease in retail customer usage. Primarily due to warmer weather during the first quarter of 2003, total retail therm sales decreased by 1 percent. The increase in electric gross margin was primarily due to the general electric rate increase of 19.3 percent in Washington base retail rates effective July 1, 2002. This increase was partially offset by the expense of the initial \$9.0 million of power supply costs in Washington exceeding the amount included in base retail rates during 2003 as compared to \$4.5 million expensed during 2002.

AVISTA CORPORATION

The following table presents Avista Utilities' electric operating revenues and megawatt-hour (MWh) sales for the years ended December 31 (dollars and MWhs in thousands):

	Electric Operating Revenues		Electric Energy MWh sales	
	2003	2002	2003	2002
Residential	\$204,783	\$196,156	3,298	3,203
Commercial	201,339	194,732	2,919	2,837
Industrial	78,276	68,096	1,785	1,519
Public street and highway lighting.....	<u>4,770</u>	<u>4,683</u>	<u>25</u>	<u>25</u>
Total retail	489,168	463,667	8,027	7,584
Wholesale.....	73,463	64,082	2,075	2,216
Sales of fuel.....	71,456	40,937	-	-
Other.....	<u>16,835</u>	<u>15,455</u>	-	-
Total	<u>\$650,922</u>	<u>\$584,141</u>	<u>10,102</u>	<u>9,800</u>

Retail electric revenues increased \$25.5 million for 2003 from 2002. This increase was primarily due to an increase in total MWhs sold (increased revenues \$27.0 million), partially offset by a decrease in revenue per MWh (decreased revenues \$1.5 million). The weather was generally warmer than 2002 during the first quarter of 2003 which reduced MWh sales during the period. However, this was offset by warmer weather during the second and third quarters of 2003, which increased residential and commercial air conditioning usage during the period. The weather was colder during the fourth quarter of 2003 as compared to the fourth quarter of 2002, which increased usage during the period. The slight decrease in revenue per MWh was due to a slight change in revenue mix with a greater percentage of revenues from industrial sales. The increase in industrial revenues was primarily due to the Potlatch Corporation contract.

Wholesale electric revenues increased \$9.4 million reflecting average sales prices that were higher than the prior period (increased revenues \$14.4 million), partially offset by a decrease in wholesale sales volumes (decreased revenues \$5.0 million). The increase in average wholesale sales prices in 2003 appears to primarily reflect decreased hydroelectric resources as compared to 2002 throughout the western United States and an increase in the cost of natural gas used for generation.

Sales of fuel increased \$30.5 million. This natural gas was not used for generation because electric wholesale market prices were generally below the cost of operating the natural gas-fired thermal generating units.

The following table presents Avista Utilities' natural gas operating revenues and therm sales for the years ended December 31 (dollars and therms in thousands):

	Natural Gas Operating Revenues		Natural Gas Therm Sales	
	2003	2002	2003	2002
Residential	\$166,925	\$183,964	198,471	199,686
Commercial	90,523	104,974	122,115	126,220
Industrial	<u>7,475</u>	<u>7,127</u>	<u>12,737</u>	<u>11,243</u>
Total retail	264,923	296,065	333,323	337,149
Wholesale.....	280	695	675	2,306
Transportation	8,485	9,664	153,352	174,891
Other.....	<u>3,601</u>	<u>3,399</u>	<u>3,124</u>	<u>2,145</u>
Total	<u>\$277,289</u>	<u>\$309,823</u>	<u>490,474</u>	<u>516,491</u>

Natural gas revenues decreased \$32.5 million for 2003 from 2002 primarily due to a decrease in retail natural gas revenues. The \$31.1 million decrease in retail natural gas revenues was primarily due to a decrease in retail rates (decreased revenues \$28.1 million) and partially due to a decrease in volumes (decreased revenues \$3.0 million). During the fourth quarter of 2002, retail rates for natural gas were reduced in response to a decrease in current and projected natural gas costs. During the fourth quarter of 2003, retail rates for natural gas were increased in response to an increase in current and projected natural gas costs. The decrease in total therms sold was a result of warmer weather during the first quarter of 2003, which was partially offset by a colder fourth quarter of 2003 as compared to 2002.

AVISTA CORPORATION

The following table presents Avista Utilities' average number of electric and natural gas customers for the years ended December 31:

	Electric Customers		Natural Gas Customers	
	2003	2002	2003	2002
Residential	283,497	279,735	261,063	254,700
Commercial	36,279	35,910	31,312	30,823
Industrial	1,414	1,420	310	315
Public street and highway lighting	422	413	-	-
Total retail	321,612	317,478	292,685	285,838
Wholesale	47	46	1	1
Transportation	-	-	84	88
Total customers	<u>321,659</u>	<u>317,524</u>	<u>292,770</u>	<u>285,927</u>

The following table presents Avista Utilities heating and cooling degree days for the years ended December 31:

	2003	2002
Heating degree days (1):		
Spokane, Washington actual	6,351	6,818
Spokane, Washington 30 year average (2)	6,820	6,842
Percentage of average	93%	100%
Medford, Oregon actual	4,046	4,230
Medford, Oregon 30 year average (2)	4,592	4,611
Percentage of average	88%	92%
Cooling degree days (3):		
Spokane, Washington actual	578	405
Spokane, Washington 30 year average (4)	394	394
Percent of average	147%	103%

- (1) Heating degree days are the measure of the coldness of weather experienced, based on the extent to which the average of the high and low temperatures for a day falls below 65 degrees Fahrenheit (annual degree days below historic indicate warmer than average temperatures).
- (2) For 2003, computed for the period from 1971 through 2000. For 2002, computed for the period from 1961 to 1990.
- (3) Cooling degree days are the measure of the warmness of weather experienced, based on the extent to which the average of the high and low temperatures for a day exceeds 65 degrees Fahrenheit (annual degree days above historic indicate warmer than average temperatures).
- (4) Computed for the period 1971 through 2000.

The following table presents Avista Utilities' resource costs for the years ended December 31 (dollars in thousands):

	2003	2002
Electric resource costs:		
Power purchased	\$147,743	\$115,282
Power cost amortizations, net of deferrals	7,165	26,253
Fuel for generation	35,581	18,531
Other fuel costs	96,765	77,885
Other regulatory amortizations, net	(7,904)	(15,411)
Other electric resource costs	<u>14,681</u>	<u>17,840</u>
Total electric resource costs	<u>294,031</u>	<u>240,380</u>
Natural gas resource costs:		
Natural gas purchased	184,014	170,662
Natural gas cost amortizations (deferrals), net	(3,336)	42,229
Other regulatory amortizations, net	218	254
Total natural gas resource costs	<u>180,896</u>	<u>213,145</u>
Total resource costs	<u>\$474,927</u>	<u>\$453,525</u>

Power purchased for 2003 increased \$32.5 million, or 28 percent, compared to 2002 primarily due to an increase in the price of power purchases (increased costs \$31.3 million) and partially due to an increase in the volume of power

purchases (increased costs \$1.2 million). The increase in the price of power purchases reflects increases in the price of power in the western United States and the Pacific Northwest. This appears to be partially due to lower than normal precipitation and snowpack conditions during the fourth quarter of 2002 and the first two months of 2003 and the anticipated effects on hydroelectric generation in the region. Warm and dry conditions in the Pacific Northwest during the summer of 2003 as well as the increased cost of natural gas used to generate electricity appear to have increased the price of electricity during 2003 as compared to 2002. Reduced hydroelectric availability and increased demand due to weather also appear to have affected wholesale electric prices in the western United States and the Pacific Northwest during the second half of 2003 as compared to 2002.

Net amortization of deferred power costs was \$7.2 million for 2003 compared to \$26.3 million for 2002. During 2003, Avista Utilities recovered (collected as revenue) \$25.8 million of previously deferred power costs in Washington and \$26.6 million in Idaho. During 2003, Avista Utilities deferred \$22.2 million of power costs in Washington and \$23.3 million in Idaho. The decrease in net amortization primarily reflects the decreased recovery of deferred power costs in Washington and an increase in the deferral of power costs in Idaho.

Fuel for generation for 2003 increased \$17.1 million compared to 2002. This was primarily due to expenses associated with natural gas used as fuel for Coyote Springs 2, which was placed into operation on July 1, 2003.

Other fuel costs for 2003 increased \$18.9 million compared to 2002. This was due to an increase in natural gas purchased as fuel for electric generation that was not used. This natural gas was sold with the associated revenues reflected as sales of fuel. Other fuel costs exceeded the revenues from selling the natural gas. This cost is accounted for under the ERM in Washington and the PCA in Idaho.

The expense for natural gas purchased for 2003 increased \$13.4 million compared to 2002 primarily due to an increase in the cost of natural gas (increased costs \$19.0 million), partially offset by a decrease in total therms purchased (decreased costs \$5.6 million) consistent with a decrease in natural gas sales. During 2003, Avista Utilities had \$3.3 million of net deferrals of natural gas costs compared to \$42.2 million of net amortization for 2002.

Energy Marketing and Resource Management

Energy Marketing and Resource Management includes the results of Avista Energy and Avista Power.

Avista Energy's earnings are primarily derived from the following activities:

- Marketing and managing the output and availability of combustion turbines and hydroelectric assets owned by other entities.
- Capturing price differences between commodities (spark spread) by converting natural gas into electricity through the power generation process.
- Purchasing and storing natural gas for later sales to seek gains from seasonal price variations and demand peaks.
- Transmitting electricity and transporting natural gas between locations, including moving energy from lower priced/demand regions to higher priced/demand markets and hub locations within the WECC.
- Taking speculative positions on future price movements within established risk management policies.

Volatility and liquidity conditions in the wholesale energy markets affect Avista Energy's earnings. Volatility in wholesale energy markets refers to the size and frequency of price movements. Liquidity represents the volume of activity in the wholesale energy markets during a given period of time and may affect the ability to conduct transactions in the wholesale market. Increases in the volatility in wholesale energy markets generally increase Avista Energy's potential earnings or losses while decreases in the volatility generally decrease Avista Energy's potential earnings or losses. Decreases in liquidity in the wholesale energy markets tend to decrease Avista Energy's earnings.

Avista Energy trades electricity and natural gas, along with derivative commodity instruments including futures, options, swaps and other contractual arrangements. Most transactions are conducted on an "over-the-counter" basis. Avista Energy's trading operations are affected by, among other things, volatility of prices within the electric energy and natural gas markets, the demand for and availability of energy, changing regulation of the electric and natural gas industries, the creditworthiness of counterparties and variations in liquidity in energy markets. See "Business Risk" for further information.

Avista Energy reports the net margin on derivative commodity instruments held for trading as operating revenues. Revenues from contracts, which are not derivatives under SFAS No. 133 and derivative commodity instruments not held for trading, are reported on a gross basis in operating revenues. Costs from contracts, which are not derivatives under SFAS No. 133 and derivative commodity instruments not held for trading, are reported on a gross basis in resource costs.

The following table presents Avista Energy's net realized gains and net unrealized losses for the years ended December 31 (dollars in thousands):

	2004	2003	2002
Net realized gains	\$39,520	\$82,317	\$141,610
Net unrealized losses	(678)	(22,128)	(87,403)
Total gross margin (operating revenues less resource costs)	<u>\$38,842</u>	<u>\$60,189</u>	<u>\$ 54,207</u>

2004 compared to 2003

Energy Marketing and Resource Management's net income was \$9.7 million for 2004, compared to net income before the cumulative effect of accounting change of \$20.7 million for 2003. During 2003, Avista Energy's earnings were positively impacted by the effects of accounting for energy contracts under SFAS No. 133 and a settlement with certain Enron affiliates. In addition, Avista Energy's earnings were decreased due to lower natural gas trading margins in 2004 as compared to 2003. These decreases were partially offset by portfolio valuation adjustments at Avista Energy of approximately \$2.9 million, net of tax, the most significant of which relates to increases in market liquidity in the Western power markets. Avista Energy's commodity portfolio was historically valued using third-party broker market quotes for the first 24 months and using a model for the long-term portion of the portfolio. Increased market liquidity has resulted in the availability of reliable and transparent market prices for a longer time period than had previously been available. Based on this change in market liquidity, Avista Energy began utilizing third-party market price quotes for the first 36 months of the portfolio beginning in the fourth quarter of 2004. Avista Energy continues to use a model to estimate forward price curves for the longer-term portion of the portfolio. The Company believes this change in valuation methodology represents the most accurate valuation of the portfolio.

Avista Energy is impacted by earnings volatility associated with the natural gas storage cycle, which runs annually from April through March of the next year. Generally, injections of natural gas into storage inventory take place in the summer months and natural gas is withdrawn from storage in the winter months. Avista Energy hedges the value of natural gas storage with financial and physical sales, effectively locking in a margin on storage. However, accounting rules require the natural gas storage to be carried at the lower of cost or market, while the sales contracts (which are derivatives) are marked-to-market using forward price curves. Changes in forward price curves result in income or losses on the derivative sales contracts, but do not affect the booked values for gas inventory. Therefore, when the month-end forward price curves change disproportionately to the cost of natural gas inventory, Avista Energy experiences earnings volatility. During the third quarter of 2004, natural gas prices increased disproportionately to the prior months' natural gas prices and negatively impacted Avista Energy's earnings. This effect was partially reversed in the fourth quarter of 2004. The earnings volatility, as well as the mark-to-market losses associated with the 2004/2005 natural gas storage cycle and the applicable accounting rules discussed above, should fully reverse when the natural gas has been withdrawn from storage. Based on natural gas prices, Avista Energy may elect not to withdraw its natural gas inventory until the first quarter of 2006. As such, the timing difference created may increase during 2005. The accounting treatment does not impact the underlying cash flows or economics of these transactions.

Avista Energy controls natural gas-fired generation through a power purchase agreement with the Lancaster Project. The power purchase agreement gives Avista Energy the right to purchase natural gas for generation, and convert to electricity for a fixed fee. Avista Energy has economically hedged the value of this power purchase agreement by entering into contracts to buy and sell natural gas and electricity. Although the power purchase agreement is not a derivative and not marked-to-market, the contracts to buy and sell natural gas and electricity are derivatives and marked-to-market. Where possible, Avista Energy has designated the natural gas and electricity contracts as accounting hedges in accordance with SFAS No. 133 in order to reduce the earnings volatility associated with these derivative contracts. However, not all of these contracts qualify for hedge accounting. Avista Energy will continue to recognize changes in fair value of those contracts in earnings as unrealized gains and losses. In addition, the ineffective portion of the change in the forward value of qualifying hedges will continue to be recognized in earnings.

Operating revenues decreased \$31.5 million and resource costs decreased \$10.1 million for 2004 as compared to 2003 resulting in a decrease in gross margin of \$21.4 million. Avista Energy's gross margin (operating revenues less resource costs) was \$38.8 million for 2004 compared to \$60.2 million for 2003. The decrease in gross margin was primarily due to the 2003 effects of the transition to SFAS No. 133 and the settlement with Enron affiliates. The transition to SFAS No. 133 resulted in certain contracts with net estimated unrecognized losses of \$7.3 million for 2003 not being accounted for at market value. These contracts that are not accounted for at market value were economically hedged by certain other contracts with net unrealized gains for 2003 that are considered derivatives under SFAS No. 133, and as such were recorded at market value with a positive effect on gross margin. The positive effect of the transition to SFAS No. 133 is reversed in future periods as market values change or the contracts are settled and realized. During September 2003, Avista Energy implemented hedge accounting for certain transactions. This has partially mitigated the effects from the transition to SFAS No. 133 and reduced the volatility of reporting earnings on a prospective basis. Avista Energy's settlement of various positions with Enron affiliates and the resulting release by Avista Energy of amounts, which had been reserved against such positions, also had a positive effect of \$8.4 million on gross margin for 2003.

Net realized gains decreased to \$39.5 million for 2004 from \$82.3 million for 2003. Net realized gains represent the net gains on contracts that have settled. The decrease in net realized gains was due to an increase in the net losses on physical natural gas transactions, the settlement with Enron affiliates in the prior year, decreased net gains on settled financial transactions and decreased net gains on settled foreign currency transactions. This was partially offset by increased net gains on settled physical electric transactions and a change in the net gain on the valuation of natural gas inventory. The total mark-to-market adjustment for Energy Marketing and Resource Management was a net unrealized loss of \$0.7 million for 2004 compared to a net unrealized loss of \$22.1 million for 2003. The change in the net unrealized loss was primarily due to the effects of the transition to SFAS No. 133 described above. The decrease in the net unrealized loss was also due to the settlement of contracts and the realization of previously unrealized gains during 2003. In 2004, portfolio valuation adjustments at Avista Energy resulting primarily from increases in market liquidity in the Western power markets decreased the net unrealized loss and increased gross margin by \$4.5 million. During 2004, the change in the total net unrealized gain attributable to market prices and other market changes was \$31.7 million, a decrease from \$63.2 million for 2003.

2003 compared to 2002

Energy Marketing and Resource Management's net income before cumulative effect of accounting change was \$20.7 million for 2003, compared to net income of \$22.4 million for 2002. This decrease was primarily due to a \$3.2 million (net of tax) impairment charge recorded by Avista Power, partially offset by an increase in gross margin for Avista Energy. Operating revenues increased \$84.5 million and resource costs increased \$78.5 million for 2003 as compared to 2002 resulting in an increase in gross margin of \$6.0 million.

Avista Energy's gross margin (operating revenues less resource costs) was \$60.2 million for 2003 compared to \$54.2 million for 2002. The increase in gross margin was partially due to the effects of the transition to SFAS No. 133, which resulted in certain contracts with net estimated unrecognized losses of \$7.3 million for 2003 not being accounted for at market value. These losses are recognized as the contracts are settled or realized. These contracts that are not accounted for at market value are economically hedged by certain other contracts with unrealized gains for 2003 that are considered derivatives under SFAS No. 133, and as such are recorded at market value with a positive impact on gross margin. The positive effects of the transition to SFAS No. 133 will be reversed in future periods as market values change or the contracts are settled and realized. Avista Energy's settlement of various positions with Enron affiliates and the resulting release by Avista Energy of amounts, which had been reserved against such positions, also had a positive effect of \$8.4 million on gross margin for 2003.

Net realized gains decreased to \$82.3 million for 2003 from \$141.6 million for 2002. Net realized gains represent the net gain on contracts that have settled. The decrease in net realized gains was primarily due to a decrease in the net gains on physical electric and natural gas transactions partially offset by the settlement with Enron affiliates, increased net gains on settled financial transactions and net gains on the change in natural gas inventory valuations. Net realized gains for 2002 also reflect net gains from the settlement of transactions that were initiated during the period of high wholesale market prices and volatility during 2000 and 2001. The total mark-to-market adjustment for Energy Marketing and Resource Management was a net unrealized loss of \$22.1 million for 2003 compared to a net unrealized loss of \$87.4 million for 2002. The change in the net unrealized loss was primarily due to the settlement of contracts with significant realized gains during 2002 and the effects of the transition to SFAS No. 133 described above. During 2003, the change in the total net unrealized gain attributable to market prices and other market changes was \$63.2 million, an increase from \$49.7 million in 2002.

Energy trading activities and positions

The following table summarizes information with respect to Avista Energy's trading activities during 2004 (dollars in thousands):

	Electric Assets net of Liabilities	Natural Gas Assets net of Liabilities	Total Unrealized Gain (Loss)
Fair value of contracts as of December 31, 2003	\$63,573	\$10,089	\$73,662
Less contracts settled during 2004 (1)	(76,854)	37,334	(39,520)
Fair value of new contracts when entered into during 2004 (2)	-	-	-
Change in fair value due to changes in valuation techniques (3)...	4,471	-	4,471
Change in fair value attributable to market prices and other market changes	<u>67,775</u>	<u>(36,082)</u>	<u>31,693</u>
Fair value of contracts as of December 31, 2004	<u>\$58,965</u>	<u>\$11,341</u>	<u>\$70,306</u>

- (1) Contracts settled during 2004 include those contracts that were open in 2003 but settled during 2004 as well as new contracts entered into and settled during 2004. Amount represents net realized gains associated with these settled transactions.
- (2) Avista Energy did not enter into any origination transactions during 2004 in which dealer profit or mark-to-market gain or loss was recorded at inception.
- (3) During the second quarter of 2004, Avista Energy refined its methodology used to discount forward settled contracts in order to reflect interest rate risk during varying settlement periods, which increased the fair value \$1.1 million. During the fourth quarter of 2004, due to increased market liquidity, Avista Energy refined its electric portfolio valuation methodology to use an additional 12 months of market data, which increased the fair value \$3.4 million.

The following table discloses summarized information with respect to valuation techniques and contractual maturities of Avista Energy's energy commodity contracts outstanding as of December 31, 2004 (dollars in thousands):

	Less than one year	Greater than one and less than three years	Greater than three and less than five years	Greater than five years	Total
Electric assets (liabilities), net					
Prices from other external sources (1)	\$23,455	\$39,174	\$ -	\$ -	\$62,629
Fair value based on valuation models (2)	<u>(1,685)</u>	<u>(2,667)</u>	<u>11,302</u>	<u>(10,614)</u>	<u>(3,664)</u>
Total electric assets (liabilities), net	<u>\$21,770</u>	<u>\$36,507</u>	<u>\$11,302</u>	<u>\$ (10,614)</u>	<u>\$58,965</u>
Natural gas assets (liabilities), net					
Prices from other external sources (1)	\$11,395	\$ 2,125	\$ -	\$ -	\$13,520
Fair value based on valuation models (3)	<u>(2,460)</u>	<u>(865)</u>	<u>1,146</u>	<u>-</u>	<u>(2,179)</u>
Total natural gas assets (liabilities), net	<u>\$ 8,935</u>	<u>\$ 1,260</u>	<u>\$ 1,146</u>	<u>\$ -</u>	<u>\$11,341</u>

- (1) Fair value is determined based upon actively traded, "over-the-counter" market quotes received from third party brokers. These market quotes are used through 36 months.
- (2) Represents contracts for delivery at basis locations not actively traded in the "over-the-counter" markets. In addition, this includes all contracts with a delivery period greater than 36 months, for which active quotes are not available. These internally developed market curves are determined using a production cost model with inputs for assumptions related to power prices (including, without limitation, natural gas prices, generation on-line, transmission constraints, future demand and weather). Avista Energy performs frequent stress tests on the valuation of the portfolio. While consistent valuation methodologies and updates to the assumptions are used to capture current market information, changes in these methodologies or underlying assumptions could result in significantly different fair values and income recognition. These same pricing techniques and stress tests are used to evaluate a contract prior to taking a position.
- (3) Represents contracts for delivery at basis locations not actively traded in the "over-the-counter" markets. In addition, this includes all contracts with a delivery period greater than 36 months, for which active quotes are not available. These internally developed market curves are based upon published New York Mercantile Exchange prices, as well as basis spreads using historical and broker estimates.

Avista Power

In 2004 and 2003, the Company recorded impairment charges for a turbine and related equipment owned by Avista Power. This resulted in charges of \$5.1 million and \$4.9 million for 2004 and 2003, respectively, included in operations and maintenance expense. The impact on net income from these impairment charges was \$3.3 million and \$3.2 million, net of tax, for 2004 and 2003, respectively.

Avista Advantage***2004 compared to 2003***

Avista Advantage had net income of \$0.6 million for 2004 compared to a net loss of \$1.3 million for 2003. Operating revenues for Avista Advantage increased \$3.6 million and operating expenses increased \$0.5 million as compared to 2003. The increase in operating revenues was primarily due to the expansion of Avista Advantage's customer base. Avista Advantage had a 29 percent increase in the number of billed sites as of December 31, 2004 as compared to December 31, 2003. The increase in operating expenses reflects the settlement of an employment contract, partially offset by improved efficiencies and a focus on reducing operating expenses. Avista Advantage's cost of processing a bill decreased by 11 percent for 2004 as compared to 2003.

2003 compared to 2002

Avista Advantage's net loss was \$1.3 million for 2003 compared to \$4.3 million for 2002. Operating revenues for Avista Advantage increased \$2.9 million and operating expenses decreased \$2.1 million as compared to 2002. The increase in operating revenues was primarily due to the expansion of Avista Advantage's customer base. Avista Advantage had a 12 percent increase in the number of billed sites as of December 31, 2003 as compared to December 31, 2002. The decrease in operating expenses reflects improved efficiencies, a reduction in the number of employees and a focus on reducing operating expenses.

Other

The Other business segment includes Avista Ventures (including AM&D), Pentzer, Avista Development and certain other operations of Avista Capital.

2004 compared to 2003

The net loss before the cumulative effect of accounting change from this business segment was \$7.2 million for 2004 compared to a net loss of \$4.9 million for 2003. The increase in the net loss was primarily due to the impairment of goodwill at AM&D, the write-off of an investment in a natural gas storage project, the accrual of an environmental liability at Avista Development and Avista Capital's purchase of Avista Advantage preferred stock at a premium. This was partially offset by a decrease in the loss from AM&D (excluding the impairment of goodwill) as well as certain other investments of Avista Ventures. Operating revenues from this business segment increased \$3.5 million and operating expenses increased \$6.8 million, respectively, for 2004 as compared to 2003. The consolidation of several minor entities pursuant to FIN 46 contributed to the increase in operating revenues and operating expenses. The loss from AM&D decreased to \$1.0 million for 2004 (excluding the impairment of goodwill), from \$2.3 million for 2003.

2003 compared to 2002

The net loss from this business segment was \$4.9 million for 2003 compared to a net loss before the cumulative effect of accounting change of \$12.4 million for 2002. The decrease in the net loss was primarily due to an increase in income from operations. Operating revenues from this business segment decreased \$1.1 million and operating expenses decreased \$12.1 million, respectively, for 2003 as compared to 2002. The increase in income from operations was primarily due to a decrease in litigation costs and settlements. The loss from AM&D decreased to \$2.3 million for 2003 from \$5.1 million for 2002. The improvement in income from operations was partially offset by an increase in losses on certain other investments of Avista Ventures not related to AM&D.

Discontinued Operations

In 2003, private equity investors made investments in a new entity, ReliOn, Inc. (formerly AVLB, Inc.), which acquired the assets previously held by Avista Corp.'s fuel cell manufacturing and development subsidiary, Avista Labs. As such, these operations are reported as a discontinued operation.

In September 2001, Avista Corp. decided that it would dispose of substantially all of the assets of Avista Communications. The divestiture of operating assets was complete by the end of 2002. The operations of Avista Communications are included as part of discontinued operations during 2002.

The decrease in the loss from discontinued operations to \$4.9 million in 2003 from \$6.7 million in 2002 was primarily due to the fact that only six months of operations for Avista Labs are included in 2003, partially offset by \$1.1 million of net income for Avista Communications in 2002.

New Accounting Standards

See "Note 2 of the Notes to Consolidated Financial Statements."

Critical Accounting Policies and Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Changes in these estimates and assumptions are considered reasonably possible and may have a material effect on the consolidated financial statements and thus actual results could differ from the amounts reported and disclosed herein. The following accounting policies represent those that the Company's management believes are particularly important to the consolidated financial statements that require the use of estimates and assumptions:

Avista Utilities Operating Revenues

Operating revenues for Avista Utilities related to the sale of energy are generally recorded when service is rendered or energy is delivered to customers. The determination of the energy sales to individual customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each calendar month, the amount of energy delivered to customers since the date of the last meter reading is estimated and the corresponding unbilled revenue is estimated and recorded. The estimate of unbilled revenue is based on the number of customers, current rates, meter reading dates, weather (degree days), as well as actual throughput for natural gas. Any difference between actual and estimated revenue is automatically corrected in the following month when the actual meter reading and customer billing occurs.

Regulatory Accounting

The Company prepares its consolidated financial statements in accordance with the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 requires the Company to reflect the impact of regulatory decisions in its financial statements. SFAS No. 71 requires that certain costs and/or obligations (such as incurred power and natural gas costs not currently recovered through rates, but expected to be recovered in the future) are reflected as deferred charges on the Consolidated Balance Sheets. These costs and/or obligations are not reflected in the statement of income until the period during which matching revenues are recognized. The Company has mechanisms in place in each regulatory jurisdiction, which provide for the recovery of its regulatory assets through future rates. These regulatory assets are subject to review for prudence and recoverability and, as such, certain deferred costs may be disallowed by the respective regulatory agencies. If at some point in the future the Company determines that it no longer meets the criteria for continued application of SFAS No. 71 with respect to all or a portion of the Company's regulated operations, the Company could be required to write off its regulatory assets. The Company could also be precluded from the future deferral of costs not recovered through rates at the time such costs are incurred, even if the Company expects to recover such costs in the future.

Avista Utilities Energy Commodity Derivative Assets and Liabilities

Avista Utilities enters into forward contracts to purchase or sell energy. Under these forward contracts, Avista Utilities commits to purchase or sell a specified amount of energy at a specified time, or during a specified period, in the future. Certain of these forward contracts are considered derivative instruments. Avista Utilities also records derivative commodity assets and liabilities for over-the-counter and exchange-traded derivative instruments as well as certain long-term contracts. These contracts are entered into as part of Avista Utilities' management of its loads and resources. In conjunction with the issuance of SFAS No. 133, the WUTC and the IPUC issued accounting

orders authorizing Avista Utilities to offset any derivative assets or liabilities with a regulatory asset or liability. This accounting treatment is intended to defer the recognition of mark-to-market gains and losses on energy commodity transactions until the period of settlement. The order provides for Avista Utilities to not recognize the unrealized gain or loss on utility derivative commodity instruments in the Consolidated Statements of Income. Realized gains or losses are recognized in the period of settlement, subject to approval for recovery through retail rates. Realized gains and losses, subject to regulatory approval, result in adjustments to retail rates through purchased gas cost adjustments, the ERM and the PCA mechanism. Quoted market prices and forward price curves are used to estimate the fair value of Avista Utilities' derivative commodity instruments.

Avista Energy Revenues and Trading Activities

Avista Energy's derivative commodity instruments accounted for under SFAS No. 133 are marked to estimated fair market value on a daily basis (mark-to-market accounting), which causes earnings variability. Changes in the market value of outstanding electric, natural gas and related derivative commodity instruments are recognized as unrealized gains or losses in the Consolidated Statements of Income in the period of change. Market prices are utilized in determining the value of electric, natural gas and related derivative commodity instruments, which are reported as assets and liabilities on the Consolidated Balance Sheets. These market prices are used through 36 months. Prior to the fourth quarter of 2004, market prices for electric commodity prices were used through 24 months. Increased market liquidity has resulted in the availability of reliable and transparent market prices for a longer time period than had been previously available. For longer-term positions and certain short-term positions for which market prices are not available, models are used to estimate market values. These models incorporate a variety of estimates and assumptions, the ultimate outcomes of which are beyond Avista Energy's control including, among others, estimates and assumptions as to demand growth, fuel price escalation, availability of existing generation and costs of new generation. Actual experience can vary significantly from these estimates and assumptions.

Avista Energy implemented hedge accounting in accordance with SFAS No. 133 during the third quarter of 2003. Specific natural gas and electric trading derivative contracts have been designated as hedging instruments in cash flow hedging relationships. The hedge strategies represent cash flow hedges of the variable price risk associated with expected purchases of natural gas and sales of electricity. These designated hedging instruments represent hedges of variable price exposures generated from certain contracts, which do not qualify as derivatives under SFAS No. 133. For all derivatives designated as cash flow hedges, Avista Energy documents the relationship between the hedging instrument and the hedged item (forecasted purchases and sales of power and natural gas), as well as the risk management objective and strategy for using the hedging instrument. Avista Energy assesses whether a change in the value of the designated derivative is highly effective in achieving offsetting cash flows attributable to the hedged item, both at the inception of the hedge and on an ongoing basis. Any changes in the fair value of the designated derivative that are effective are recorded in accumulated other comprehensive income or loss, while changes in fair value that are not effective are recognized currently in earnings as operating revenues. Amounts recorded in accumulated other comprehensive income or loss are recognized in earnings during the period that the hedged items are recognized in earnings.

Pension Plans and Other Postretirement Benefit Plans

The Company has a defined benefit pension plan covering substantially all of its regular full-time employees at Avista Utilities and Avista Energy. Individual benefits under this plan are based upon the employee's years of service and average compensation as specified in the plan. The Company's funding policy is to contribute at least the minimum amounts that are required to be funded under the Employee Retirement Income Security Act, but not more than the maximum amounts that are currently deductible for income tax purposes. The Company made \$15 million in cash contributions to the pension plan in 2004 and \$12 million in each of 2003 and 2002. The Company expects to contribute approximately \$15 million to the pension plan in 2005. As of December 31, 2004, the Company's pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. In 2004, the pension plan funding deficit increased as compared to the end of 2003 primarily as a result of a decrease in the discount rate used to measure pension plan liabilities. As such, the Company increased the additional minimum liability for the unfunded accumulated benefit obligation by \$9.2 million and decreased the intangible asset by \$0.7 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in a charge to other comprehensive income of \$6.4 million, net of tax, for 2004.

The Finance Committee of the Company's Board of Directors establishes investment policies, objectives and strategies to seek optimum return for the pension plan, while also keeping with the assumption of prudent risk and the Finance Committee's composite return objectives. The Finance Committee reviews and approves changes to the investment policy. The Company has contracted with an investment manager who is responsible for managing the individual investment managers. The investment manager's performance and related individual fund performance is periodically reviewed by the Finance Committee to ensure compliance with investment policy objectives and

strategies. Pension plan assets are invested primarily in marketable debt and equity securities. Pension plan assets may also be invested in real estate and other investments, including hedge funds and venture capital funds. In seeking to obtain the desired return to fund the pension plan, the Finance Committee has established investment allocation percentages by asset classes as disclosed in "Note 11 of the Notes to Consolidated Financial Statements."

The Company's pension costs (including its Supplemental Executive Retirement Plan (SERP)) were \$14.9 million, \$16.1 million and \$10.3 million for 2004, 2003 and 2002, respectively. Of these pension costs, approximately 70 percent are expensed and approximately 30 percent are capitalized. The Company's costs for the pension plan are determined in part by actuarial formulas and are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. Pension costs are affected by actual employee demographics (including age, compensation and length of service by employees), the amount of cash contributions the Company makes to the pension plan and the return on pension plan assets. Changes made to the provisions of the pension plan may also impact current and future pension costs. Pension plan costs may also be significantly affected by changes in key actuarial assumptions, including the expected return on pension plan assets, the discount rate used in determining the projected benefit obligation and pension costs, as well as the assumed rate of increase in employee compensation. The change in pension plan obligations associated with these factors may not be immediately recognized as pension costs in the Consolidated Statement of Income, but generally are recognized in future years over the remaining average service period of pension plan participants. As such, costs recorded in any period may not reflect the actual level of cash benefits provided to pension plan participants.

The Company has not made any changes to pension plan provisions in 2004, 2003 and 2002 that have had any significant effect on recorded pension plan amounts. The Company has revised the key assumption of the discount rate in 2004 and 2003. Such change had an effect on reported pension costs in 2004 and 2003 and may have an impact on future years given the cost recognition approach described above. However, in determining pension obligation and cost amounts, assumptions can change from period to period, and such changes could result in material changes to future pension costs and funding requirements.

The following chart reflects the sensitivities associated with a change in certain actuarial assumptions by the indicated percentage (dollars in thousands):

Actuarial Assumption	Change in Assumption	Impact on Projected Benefit Obligation	Impact on Pension Liability	Impact on Pension Cost
Expected long-term return on plan assets	-0.5%	\$ -	\$ -*	\$839
Expected long-term return on plan assets	+0.5%	-	-*	(839)
Discount rate	-0.5%	17,817	13,069	1,541
Discount rate	+0.5%	(16,099)	(11,893)	(1,409)

* As the Company has already recorded an additional minimum liability for the unfunded accumulated benefit obligation, changes in the expected return on plan assets would not have an impact on the total pension liability.

In selecting a discount rate, the Company considers yield rates for highly rated corporate bond portfolios with maturities similar to that of the expected term of pension benefits. The Company reduced the discount rate in 2004 to 5.75 percent from 6.25 percent. The Company reduced the discount rate in 2003 to 6.25 percent from 6.75 percent. These decreases in discount rates have increased the projected benefit obligation, pension liability and pension costs.

The assumed long-term rate of return on plan assets is based on past performance and economic forecasts for the types of investments held by the plan. The assumed long-term rate of return was 8 percent in both 2004 and 2003. For 2004 and 2003, the actual return on plan assets, net of fees, was a gain of \$16.1 million (or 10.4 percent) and \$32.3 million (or 23.3 percent), respectively. The actual return on plan assets, net of fees, was a loss of \$17.4 million (or 11.3 percent) in 2002.

The Company also has a SERP that provides additional pension benefits to executive officers of the Company. The SERP is intended to provide benefits to executive officers whose benefits under the pension plan are reduced due to the application of Section 415 of the Internal Revenue Code of 1986 and the deferral of salary under deferred compensation plans. The Company recorded an additional minimum liability for the unfunded accumulated benefit obligation of \$1.8 million, \$0.3 million and \$0.7 million related to the SERP in 2004, 2003 and 2002, respectively. This resulted in a charge to other comprehensive income of \$1.2 million, \$0.2 million and \$0.5 million, net of tax, for 2004, 2003 and 2002, respectively.

The Company provides certain health care and life insurance benefits for substantially all of its retired employees. The Company accrues the estimated cost of postretirement benefit obligations during the years that employees provide services. Assumed health care cost trend rates have a significant effect on the amounts reported for the postretirement plans. A one-percentage-point increase in the assumed health care cost trend rate for each year would increase the accumulated postretirement benefit obligation as of December 31, 2004 by \$2.3 million and the service and interest cost by \$0.2 million. A one-percentage-point decrease in the assumed health care cost trend rate for each year would decrease the accumulated postretirement benefit obligation as of December 31, 2004 by \$2.0 million and the service and interest cost by \$0.2 million.

Contingencies

The Company has unresolved regulatory, legal and tax issues for which there is inherent uncertainty with respect to the ultimate outcome of the respective matter. The Company accounts for contingencies in accordance with SFAS No. 5, "Accounting for Contingencies," as well as other accounting guidance specific to a particular issue. In accordance with SFAS No. 5, a loss contingency is accrued if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss or impairment can be reasonably estimated. The Company also discloses losses that do not meet these conditions for accrual, if it there is a reasonable possibility that a loss may be incurred.

For all material contingencies, the Company has made a judgment as to the probability of the loss occurring and as to whether or not the amount of the loss can be estimated, and, if the loss recognition criteria have been met, liabilities have been accrued or assets have been written down. However, no assurance can be given with respect to the ultimate outcome of any particular contingency.

Liquidity and Capital Resources**Review of Cash Flow Statement**

Continuing Operating Activities Net cash provided by continuing operating activities was \$108.3 million for 2004 compared to \$122.6 million for 2003. The primary reason for the decrease in net cash provided by continuing operating activities was an increase in net cash used in working capital components, a change in energy commodity assets and liabilities as well as a decrease in net income. This was partially offset by net sales of securities held for trading in 2004 as compared to purchases in 2003 and the fact that non-cash write-offs and impairments were a primary cause for the decrease in net income. Power and natural gas cost amortizations, net of deferrals, were \$11.1 million for 2004 compared to \$3.8 million for 2003. This was primarily due to decreased deferrals (and a corresponding decrease in cash paid for electric resources) of deferred power costs, partially offset by increased deferrals (and a corresponding increase in cash paid for natural gas purchases) of natural gas costs. The amortization of deferred power and natural gas costs is substantially matched by an increase in cash revenues collected from customers. Increases in cash resource costs paid for power and natural gas costs are substantially matched by additions to deferred power and natural gas costs. Net cash used in working capital components was \$89.6 million for 2004, compared to net cash used of \$43.0 million for 2003. The net cash used in 2004 primarily reflects a decrease in deposits from counterparties (representing funds returned), which have substituted cash collateral with letters of credit, and an increase in restricted cash (representing cash deposits as collateral for letters of credit). This was partially offset by an increase in accounts payable. The net cash used in 2003 primarily reflects a net decrease in accounts payable. Significant changes in non-cash items included a \$21.4 million change in energy commodity assets and liabilities, representing the change from an unrealized loss of \$22.1 million on energy trading activities for Avista Energy for 2003 to an unrealized loss of \$0.7 million for 2004. This decrease reflects a decrease in realized gains and cash receipts on settled energy commodity transactions at Avista Energy. Significant non-cash items for 2004 also included the write-off and impairment of assets totaling \$22.0 million, which is comprised of \$12.0 million of deferred power costs, \$2.4 million of utility plant costs pursuant to the Idaho general rate case order, asset impairment charges of \$5.1 million at Avista Power, goodwill impairment of \$1.4 million at AM&D (Other business segment) and \$1.1 million representing the write-off of an investment in a natural gas storage project in the Other business segment. The net sales of securities held for trading of \$18.9 million (sales of \$34.2 million and purchases of \$15.3 million) for 2004 represents the investment of cash held at Avista Energy in short-term instruments.

Continuing Investing Activities Net cash used in continuing investing activities was \$119.4 million for 2004, an increase compared to \$109.8 million for 2003. The increase was primarily due to an increase in utility property capital expenditures and a \$5.0 million deposit for the purchase of Coyote Springs 2 in 2004, partially offset by changes in property and investments and an increase in proceeds from the sale of assets.

Continuing Financing Activities Net cash used in continuing financing activities was \$28.7 million for 2004 compared to \$54.5 million for 2003. During 2004, short-term borrowings decreased \$12.0 million, which primarily reflects a decrease in the amount of debt outstanding under Avista Corp.'s line of credit. During 2004, the Company repurchased \$36.6 million of long-term debt scheduled to mature in future years at a total premium of \$6.7 million, and \$30.3 million of debt matured. In November 2004, the Company issued \$90.0 million (net proceeds of \$89.8 million) of 5.45 percent First Mortgage Bonds due in 2019. During 2004, the Company had \$61.9 million of cash inflows and outflows related to the issuance and redemption of long-term debt to affiliated trusts. In 2004, Avista Capital purchased the preferred stock of Avista Advantage at a total price of \$4.3 million (including a premium of \$0.9 million).

During 2003, short-term borrowings increased \$50.5 million, the Company repurchased \$52.5 million of long-term debt scheduled to mature in future years at a premium of \$1.7 million, and \$72.4 million of long-term debt matured. In September 2003, the Company issued \$45.0 million (net proceeds of \$44.8 million) of 6.125 percent First Mortgage Bonds due in 2013. The increase in short-term borrowings primarily reflects an increase in the amount of debt outstanding under Avista Corp.'s line of credit. The increase in the amount of short-term borrowings reflects decreased cash flows from operations and increased funding needed for capital expenditures, maturing long-term debt and discretionary repurchases of long-term debt scheduled to mature in future years.

Overall Liquidity

The Company's consolidated operating cash flows are primarily derived from the operations of Avista Utilities and Avista Energy. The primary source of operating cash flows for Avista Utilities is revenues (including the recovery of previously deferred power and natural gas costs) from sales of electricity and natural gas. Significant uses of cash flows from operations include the purchase of electricity and natural gas, other operating expenses, taxes and interest.

AVISTA CORPORATION

The primary source and use of operating cash flows for Avista Energy is revenues and costs from realized energy commodity transactions as well as cash collateral deposited to or held from counterparties. Significant operating cash outflows for Avista Energy also include other operating expenses and taxes.

Operating cash flows do not always fully support the capital expenditure needs of Avista Utilities. As such, from time to time, the Company may need to access capital markets in order to fund these needs as well as fund maturing debt. See further discussion at "Capital Resources."

Since 2002, the Company's overall liquidity has improved compared to 2001. The general rate increases that became effective in 2002, 2003 and 2004 are allowing the Company to continue to improve its liquidity. The 2002 general electric rate increase in Washington provided for the restructuring and continuation of previously approved temporary rate increases totaling 31.2 percent. In 2003, the Company received a general rate increase, designed to increase annual revenues by \$6.3 million in Oregon. In September 2004, the Company received general rate increases, designed to increase base annual revenues by \$24.7 million for electric and \$3.3 million for natural gas service in Idaho. The Idaho base electric rate increase was substantially offset by a decrease in the PCA surcharge and other minor adjustments such that the net increase in revenues is designed to be \$3.2 million. However, the increase in base electric rates will have a significant effect on recurring retail revenues and liquidity. In November 2004, a natural gas general rate increase, designed to increase annual revenues by \$5.4 million, was implemented in Washington. See further details in the section "Avista Utilities - Regulatory Matters."

The Company designs operating and capital budgets to control operating costs and capital expenditures. In addition to operating expenses, the Company has continuing commitments for capital expenditures for construction, improvement and maintenance of facilities. In 2001, the Company incurred substantial levels of indebtedness, both short and long-term, to fund high power and natural gas costs in addition to these continuing requirements and to otherwise maintain adequate levels of working capital. As a result of improved operating cash flow and other sources of funds, since 2002 through 2004, the Company has repurchased \$292.7 million of long-term debt.

When Avista Utilities' power and natural gas costs exceed the levels currently recovered from retail customers, its net cash flows are negatively affected. Factors that could cause purchased power costs to exceed the levels currently recovered from customers include, but are not limited to, higher prices in wholesale markets combined with an increased need to purchase power in the wholesale markets. Factors beyond the Company's control that could result in an increased need to purchase power in the wholesale markets include, but are not limited to, increases in demand (either due to weather or customer growth), low availability of hydroelectric resources, outages at generating facilities and failure of third parties to deliver on energy or capacity contracts. Based on forecasts as of March 1, 2005, Avista Utilities expects hydroelectric generation will be approximately 84 percent of normal in 2005 assuming normal precipitation for the remainder of the year. This expectation may change based upon precipitation, temperatures and other variables. The earnings impact of below normal hydroelectric generation is mitigated through power cost deferral and recovery mechanisms in Washington and Idaho. The expected reduction in hydroelectric generation is estimated to have a negative effect on operating cash flows of approximately \$25 million from the amount originally forecasted, with approximately \$2.5 million impacting pre-tax earnings. Avista Utilities believes that it has adequate liquidity through cash flows generated from operations and funds available under its committed line of credit to meet increased cash requirements for purchased power or fuel as a result of reduced hydroelectric generation.

Capital Resources

The Company's consolidated capital structure, including the current portion of long-term debt and short-term borrowings consisted of the following as of December 31 (dollars in thousands):

	2004		2003	
	Amount	Percent of total	Amount	Percent of total
Current portion of long-term debt.....	\$ 85,432	4.4%	\$ 29,711	1.5%
Short-term borrowings.....	68,517	3.5	80,525	4.2
Long-term debt to affiliated trusts.....	113,403	5.8	113,403	5.9
Long-term debt.....	<u>901,556</u>	<u>46.2</u>	<u>925,012</u>	<u>47.9</u>
Total debt.....	1,168,908	59.9	1,148,651	59.5
Preferred stock-cumulative (including current portion).....	<u>29,750</u>	<u>1.5</u>	<u>31,500</u>	<u>1.6</u>
Total liabilities.....	1,198,658	61.4	1,180,151	61.1
Common equity.....	<u>753,205</u>	<u>38.6</u>	<u>751,252</u>	<u>38.9</u>
Total.....	<u>\$1,951,863</u>	<u>100.0%</u>	<u>\$1,931,403</u>	<u>100.0%</u>

The Company's total debt increased from December 31, 2003 to December 31, 2004 due to the issuance of long-term debt, partially offset by a decrease in short-term borrowings and the repurchase and maturity of long-term debt. The Company needs to finance capital expenditures and obtain additional working capital from time to time. The cash requirements needed to service indebtedness, both short-term and long-term, reduces the amount of cash flow available to fund working capital, purchased power and natural gas costs, capital expenditures, dividends and other corporate requirements. The Company's consolidated common equity increased \$2.0 million during 2004 primarily due to net income and the issuance of common stock through the Dividend Reinvestment Plan, partially offset by dividends and other comprehensive loss.

The Company generally funds capital expenditures with a combination of internally generated cash and external financing. The level of cash generated internally and the amount that is available for capital expenditures fluctuates depending on a variety of factors. Cash provided by utility operating activities and cash generated by Avista Energy are expected to be the Company's primary sources of funds for operating needs, dividends and capital expenditures for 2005. Borrowings under Avista Corp.'s committed line of credit may supplement these funds to the extent necessary.

In April 2004, the Company issued Junior Subordinated Debt Securities, with a principal amount of \$61.9 million to AVA Capital Trust III, an affiliated business trust formed by the Company. Concurrently, AVA Capital Trust III issued \$60.0 million of Preferred Trust Securities to third parties and \$1.9 million of Common Trust Securities to the Company. All of these securities have a fixed interest rate of 6.50 percent for five years (through March 31, 2009). Subsequent to the initial five-year fixed rate period, the securities will either have a new fixed rate or an adjustable rate. These debt securities may be redeemed by the Company on or after March 31, 2009 and will mature on April 1, 2034.

The Company used the proceeds from the Junior Subordinated Debt Securities to redeem \$61.9 million of 7.875 percent Junior Subordinated Deferrable Interest Debentures, Series A, originally issued in 1997 to Avista Capital I, an affiliated business trust formed by the Company. Avista Capital I used these proceeds to redeem \$60.0 million of Preferred Trust Securities issued to third parties and \$1.9 million of Common Trust Securities issued to the Company.

In November 2004, the Company issued \$90.0 million of 5.45 percent First Mortgage Bonds due in 2019. The Company used the proceeds to repay a portion of the borrowings outstanding under its committed line of credit.

On December 17, 2004, the Company entered into a five-year committed line of credit with various banks in the amount of \$350.0 million with an expiration date of December 16, 2009. This committed line of credit replaced a \$350.0 million committed line of credit with a 364-day term that had an expiration date of May 5, 2005. The Company can request the issuance of up to \$150.0 million in letters of credit under the committed line of credit. As of December 31, 2004 and 2003, the Company had \$68.0 million and \$80.0 million, respectively, of borrowings outstanding. As of December 31, 2004 and 2003, there were \$32.8 million and \$10.7 million in letters of credit outstanding, respectively. The committed line of credit is secured by \$350.0 million of non-transferable First Mortgage Bonds of the Company issued to the agent bank. Such First Mortgage Bonds would only become due and payable in the event, and then only to the extent, that the Company defaults on its obligations under the committed line of credit. However, if the Company obtains an investment grade senior unsecured rating with a stable outlook from two nationally recognized rating agencies, it has the option to release such security.

The committed line of credit agreement contains customary covenants and default provisions, including covenants not to permit the ratio of "consolidated total debt" to "consolidated total capitalization" of Avista Corp. to be greater than 70 percent at the end of any fiscal quarter. As of December 31, 2004, the Company was in compliance with this covenant with a ratio of 59.9 percent. The committed line of credit also has a covenant requiring the ratio of "earnings before interest, taxes, depreciation and amortization" to "interest expense" of Avista Utilities for the twelve-month period ending December 31, 2004 to be greater than 1.6 to 1. As of December 31, 2004, the Company was in compliance with this covenant with a ratio of 2.27 to 1.

Any default on the line of credit or other financing arrangements of Avista Corp. or any of its significant subsidiaries could result in cross-defaults to other agreements of such entity; and/or to the line of credit or other financing arrangements of any other of such entities, and could induce vendors and other counterparties to demand collateral. In the event of any such default, it would be difficult for the Company to obtain financing on reasonable terms to pay creditors or fund operations, and the Company would likely be prohibited from paying dividends on its common stock. Avista Corp. does not guarantee the indebtedness of any of its subsidiaries. As of December 31, 2004, Avista Corp. and its subsidiaries were in compliance with the covenants of all of their financing agreements.

AVISTA CORPORATION

The Company is restricted under various agreements and its Restated Articles of Incorporation as to the additional preferred stock it can issue. As of December 31, 2004, approximately \$304.0 million of additional preferred stock could be issued at an assumed dividend rate of 6.95 percent with a maturity date later than June 1, 2008.

The Mortgage and Deed of Trust securing the Company's First Mortgage Bonds (including Secured Medium-Term Notes) contains limitations on the amount of First Mortgage Bonds that may be issued based on, among other things, a 70 percent debt-to-collateral ratio, and/or retired First Mortgage Bonds, and a 2 to 1 net earnings to First Mortgage Bond interest ratio. As of December 31, 2004, the Company could issue \$400.0 million of additional First Mortgage Bonds under the Mortgage and Deed of Trust.

In April 2004, the Company filed an amended registration statement on Form S-3 with the Securities and Exchange Commission, which would allow for the issuance of up to \$349.6 million of securities (either debt or common stock). This filing amended and combined three previous registration statements filed by the Company. As of December 31, 2004, the Company had remaining availability of \$259.6 million under this registration statement.

In July, August and December 2004, Avista Corp. entered into three forward-starting interest rate swap agreements, totaling \$200.0 million, to manage the risk that changes in interest rates may affect the amount of future interest payments. These interest rate swap agreements relate to the anticipated issuances of debt to fund debt that matures in 2007 and 2008. Under the terms of these agreements, the value of the interest rate swaps are determined based upon Avista Corp. paying a fixed rate and receiving a variable rate based on LIBOR for a term of seven years beginning in 2007 and a term of ten years beginning in 2008. The interest rate swap agreements provide for mandatory cash settlement of these contracts in 2008 and 2009. These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. As of December 31, 2004, Avista Corp. had a derivative liability of \$6.5 million. An unrealized loss of \$4.2 million (net of taxes of \$2.3 million) was recorded in other comprehensive loss for 2004, which is reflected as component of accumulated other comprehensive loss on the Consolidated Balance Sheet. The Company may request regulatory accounting orders to defer the impact of unrealized gains and losses. If such accounting orders were obtained, the Company would record a regulatory asset or liability, which would eliminate the effect of any unrealized gains and losses on these interest rate swap agreements in the Consolidated Statements of Comprehensive Income.

In January and February 2005, Avista Corp. redeemed a total of \$26.0 million of medium-term notes scheduled to mature in future years.

Inter-Company Debt; Subordination

As part of its on-going cash management practices and operations, Avista Corp. from time to time makes unsecured short-term loans to, and obtains borrowings from, Avista Capital. In turn, Avista Capital from time to time makes unsecured short-term loans to, and obtains borrowings from, its subsidiaries. As of December 31, 2004, Avista Corp. held a short-term subordinated note receivable from Avista Capital in the principal amount of \$42.0 million. In addition, Avista Capital from time to time guarantees the indebtedness and other obligations of its subsidiaries. See "Energy Marketing and Resource Management Operations" for further information.

The credit arrangements of Avista Capital's subsidiaries generally provide that any indebtedness owed by such entity to its corporate parent will be subordinated to the indebtedness outstanding under such credit arrangements.

The right of Avista Corp., as a shareholder, to receive assets of any of its direct or indirect subsidiaries upon the subsidiary's liquidation or reorganization (and the consequent right of the holders of debt securities and other creditors of Avista Corp. to participate in those assets) is subordinated to the claims against such assets of that subsidiary's creditors. As a result, the obligations of Avista Corp. to its debt securityholders and other unrelated creditors are effectively subordinated in right of payment to all indebtedness and other liabilities and commitments (including trade payables and lease obligations) of Avista Corp.'s direct and indirect subsidiaries. Similarly, the obligations of Avista Capital to its creditors are effectively subordinated in right of payment to all indebtedness and other liabilities and commitments of its direct and indirect subsidiaries.

Pension Plan

As of December 31, 2004, the Company's pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. The Company does not expect the current pension plan funding deficit to have a material adverse impact on its financial condition, results of operations or cash flows. The

Company made \$15 million in cash contributions to the pension plan in 2004 and \$12 million in 2003. The Company expects to make pension plan contributions of \$15 million in 2005.

Off-Balance Sheet Arrangements

Avista Receivables Corp. (ARC) is a wholly owned, bankruptcy-remote subsidiary of the Company formed in 1997 for the purpose of acquiring or purchasing interests in certain accounts receivable, both billed and unbilled, of the Company. On May 29, 2002, ARC, the Company and a third-party financial institution entered into a three-year agreement whereby ARC can sell without recourse, on a revolving basis, up to \$100.0 million of those receivables. In April 2004, the revolving amount available for sale was reduced to \$85.0 million. ARC is obligated to pay fees that approximate the purchaser's cost of issuing commercial paper equal in value to the interests in receivables sold. As of December 31, 2004, \$72.0 million in receivables were sold pursuant to the revolving agreement. This agreement provides the Company with cost-effective funds for working capital requirements, capital expenditures and other general corporate needs. The Company expects to renew this facility before the May 2005 expiration.

Spokane Energy, LLC

In December 1998, the Company received cash proceeds of \$143.4 million from a transaction in which the Company assigned and transferred certain rights under a long-term power sales contract with Portland General Electric Corporation (PGE) to a funding trust. Pursuant to orders from the WUTC and IPUC, this amount was fully amortized by the end of 2002.

Under this power exchange arrangement, Peaker, LLC (Peaker) purchases capacity from Avista Corp. and sells capacity to Spokane Energy LLC (Spokane Energy), an unconsolidated subsidiary of Avista Corp., formed in 1998 solely for the purpose of facilitating a long-term capacity contract between PGE and Avista Corp. Spokane Energy sells the related capacity to PGE. Peaker acts as an intermediary to fulfill certain regulatory requirements between Spokane Energy and Avista Corp. from dealing directly with each other. The transaction is structured such that Spokane Energy bears full recourse risk for a loan (balance of \$113.6 million as of December 31, 2004) that matures in January 2015 with no recourse to Avista Corp. related to the loan. Peaker is obligated to pay approximately \$150,000 per month to Avista Corp. for its capacity purchase. Peaker was formed solely for the purpose of assuming all rights and obligations from Enron Power Marketing, Inc. (EPMI), which assigned the transactions to Peaker in November 2003 as part of its bankruptcy proceedings. Peaker is not affiliated with EPMI.

Credit Ratings

The following table summarizes the Company's credit ratings as of February 28, 2005:

	<u>Standard & Poor's</u>	<u>Moody's</u>	<u>Fitch, Inc.</u>
Avista Corporation			
Corporate/Issuer rating	BB+	Ba1	BB+
Senior secured debt	BBB-	Baa3	BBB-
Senior unsecured debt	BB+	Ba1	BB+
Preferred stock	BB-	Ba3	BB
Avista Capital II (1)			
Preferred Trust Securities	BB-	Ba2	BB
AVA Capital Trust III (1)			
Preferred Trust Securities	BB-	Ba2	BB
Rating outlook	Stable	Stable (2)	Stable

(1) Only assets are subordinated debentures of Avista Corporation.

(2) Changed to stable from negative in March 2004.

These security ratings are not recommendations to buy, sell or hold securities. The ratings are subject to change or withdrawal at any time by the respective credit rating agencies. Each credit rating should be evaluated independently of any other ratings.

Dividends

The Board of Directors considers the level of dividends on the Company's common stock on a regular basis, taking into account numerous factors including, without limitation, the Company's results of operations, cash flows and

financial condition, as well as the success of the Company's strategies and general economic and competitive conditions. The Company's net income available for dividends is derived primarily from the operations of Avista Utilities and Avista Energy.

Covenants under the Company's 9.75 percent Senior Notes that mature in 2008 limit the Company's ability to increase its common stock cash dividend to no more than 5 percent over the previous quarter.

On February 11, 2005, the Board of Directors declared a quarterly dividend of \$0.135 per common share payable on March 15, 2005 to shareholders of record on February 25, 2005. This is an increase of \$0.005 per common share over the previous quarterly dividend declared in November 2004 and the third such increase authorized by the Board of Directors in the last 18 months.

Avista Energy holds a significant portion of cash and cash equivalents reflected on the Consolidated Balance Sheets. Covenants in Avista Energy's credit agreement, certain counterparty agreements and current market liquidity conditions result in Avista Energy maintaining certain levels of cash and therefore effectively limiting the amount of cash dividends that are available for distribution to Avista Capital and ultimately to Avista Corp. During 2004, Avista Energy paid \$2.5 million of dividends to Avista Capital. In March 2005, Avista Energy paid \$10.0 million in dividends to Avista Capital.

Avista Utilities Operations

Capital expenditures for Avista Utilities were \$281.8 million for the years 2002 through 2004. This excludes Coyote Springs 2, which was included in Energy Marketing and Resource Management for 2002. During the years 2005 through 2007, utility capital expenditures are currently expected to be in the range of \$135 million to \$150 million per year (excluding the \$62.5 million purchase of Coyote Springs 2 in 2005). Long-term debt maturities, mandatory redemptions of preferred stock and sinking fund requirements are expected to total approximately \$322 million. During 2005, internally generated funds and short-term borrowing arrangements are expected to be sufficient to fund these requirements with the exception of the maturing \$54.6 million of debt for WP Funding LP, which is expected to be refinanced on a long-term basis. In years subsequent to 2005, the Company will most likely need to issue additional long-term debt to fund these obligations. These estimates of capital expenditures are subject to continuing review and adjustment. Actual capital expenditures may vary from these estimates due to factors such as changes in business conditions, construction schedules and environmental requirements. Avista Utilities' planned capital expenditures include an expansion and enhancement of its 230 kV transmission system with estimated remaining costs of approximately \$77 million that Avista Utilities expects will be completed by the end of 2007.

Cash deposits from other parties in the net amount of \$19.0 million were returned during 2004 because of continuing portfolio value fluctuations with those parties or substitution of collateral. The decrease was primarily the result of the substitution of letters of credit in place of cash collateral.

In January 2005, the Company completed the purchase of Mirant Oregon's 50 percent ownership interest in Coyote Springs 2 at a price of \$62.5 million. See "Note 28 of the Notes to Consolidated Financial Statements" for further information.

In July 2004, Avista Corp. reached an agreement to sell its South Lake Tahoe natural gas distribution properties to Southwest Gas Corporation. The agreed upon cash purchase price for the properties is approximately \$15 million, subject to closing adjustments. The Company expects that the transaction will close during the first half of 2005. See "Note 27 of the Notes to Consolidated Financial Statements" for further information.

As of December 31, 2004, Avista Utilities had \$2.0 million in cash and temporary investments. Avista Utilities also had \$0.6 million of restricted cash as of December 31, 2004 related to Avista Corp.'s interest rate swap agreements.

See "Notes 5, 14, 15, 16, 19, 20, 21 and 22 of Notes to Consolidated Financial Statements" for additional details related to financing activities.

Energy Marketing and Resource Management Operations

On July 23, 2004, Avista Energy and its subsidiary, Avista Energy Canada, as co-borrowers, amended its committed credit agreement with a group of banks in the aggregate amount of \$110.0 million to extend the expiration date to July 22, 2005. This committed credit facility provides for the issuance of letters of credit to secure contractual obligations to counterparties. This facility is guaranteed by Avista Capital and secured by the assets of Avista Energy and Avista

Energy Canada. The maximum amount of credit extended by the banks for the issuance of letters of credit is the subscribed amount of the facility less the amount of outstanding cash advances, if any. The maximum amount of credit extended by the banks for cash advances is \$30.0 million. No cash advances were outstanding as of December 31, 2004. Letters of credit in the aggregate amount of \$91.3 million were outstanding as of December 31, 2004. The cash deposits of Avista Energy at the respective banks collateralize \$21.5 million of these letters of credit, which is reflected as restricted cash on the Consolidated Balance Sheet.

The Avista Energy credit agreement contains customary covenants and default provisions, including covenants to maintain "minimum net working capital" and "minimum net worth," as well as a covenant limiting the amount of indebtedness that the co-borrowers may incur. The credit agreement also contains covenants and other restrictions related to Avista Energy's trading limits and positions, including VAR limits, restrictions with respect to changes in risk management policies or volumetric limits, and limits on exposure related to hourly and daily trading of electricity. Also, a reduction in the credit rating of Avista Corp. would represent an event of default under Avista Energy's credit agreement. These covenants, certain counterparty agreements and current market liquidity conditions result in Avista Energy maintaining certain levels of cash and therefore effectively limit the amount of cash dividends that are available for distribution to Avista Capital and ultimately to Avista Corp. Avista Energy was in compliance with the covenants of its credit agreement as of December 31, 2004.

Avista Capital provides guarantees for Avista Energy's credit agreement (see discussion above) and, in the course of business, may provide performance guarantees to other parties with whom Avista Energy may be doing business. At any point in time, Avista Capital is only liable for the outstanding portion of the performance guarantee, which was \$24.5 million as of December 31, 2004. The face value of all performance guarantees issued by Avista Capital for energy trading contracts at Avista Energy was \$391.7 million as of December 31, 2004.

As part of its cash management practices and operations, Avista Energy from time to time makes unsecured short-term loans to its parent, Avista Capital. Avista Capital's Board of Directors has limited the total outstanding indebtedness to no more than \$45.0 million. Further, as required under Avista Energy's credit facility, such loans cannot be outstanding longer than 90 days without being repaid. During 2004, Avista Energy's maximum total outstanding short-term loan to Avista Capital was \$40.1 million including accrued interest. As of December 31, 2004, all outstanding loans including accrued interest had been repaid.

Avista Energy manages collateral requirements with counterparties by providing letters of credit, providing guarantees from Avista Capital, depositing cash with counterparties and offsetting transactions with counterparties. Cash deposited with counterparties totaled \$30.7 million as of December 31, 2004, which is included in prepayments and other current assets on the Consolidated Balance Sheet. Avista Energy held cash deposits from other parties in the amount of \$6.0 million as of December 31, 2004, which is included in cash and cash equivalents with a corresponding amount in deposits from counterparties on the Consolidated Balance Sheet. This is a significant decrease from \$78.8 million held at December 31, 2003. These amounts are subject to return if conditions warrant because of continuing portfolio value fluctuations with those parties or substitution of collateral. The decrease was primarily the result of the substitution of letters of credit in place of cash collateral.

As of December 31, 2004, Avista Energy had \$110.3 million in cash, including \$25.6 million of restricted cash and \$6.0 million of cash deposits from other parties.

During 2004, Avista Energy paid \$2.5 million of dividends to Avista Capital. In March 2005, Avista Energy paid \$10.0 million in dividends to Avista Capital.

Capital expenditures for the Energy Marketing and Resource Management companies were \$21.0 million for the years 2002 through 2004. Capital expenditures in 2002 of \$17.5 million were primarily related to Avista Power's construction of Coyote Springs 2, which was subsequently transferred to Avista Utilities. Capital expenditures are expected to be less than \$2.0 million per year in this business segment during the years 2005 through 2007.

Avista Advantage Operations

Capital expenditures for Avista Advantage were \$2.4 million for the years 2002 through 2004. Capital expenditures for the years 2005 through 2007 are expected to total approximately \$6.5 million and should be funded by Avista Advantage's cash flows from operations.

AVISTA CORPORATION

As of December 31, 2004, Avista Advantage had \$0.3 million of cash and cash equivalents and \$1.7 million in debt was outstanding. Avista Advantage's outstanding debt is related to capital leases.

Other Operations

Capital expenditures for these companies were \$2.0 million for the years 2002 through 2004. Capital expenditures for the years 2005 through 2007 are expected to be less than \$1.0 million per year. As of December 31, 2004, this business segment had \$1.4 million of cash and cash equivalents and \$7.8 million in debt was outstanding. The outstanding debt includes long-term debt, short-term borrowings and capital leases.

Contractual Obligations

The following table provides a summary of the Company's future contractual obligations as of December 31, 2004 (dollars in millions):

	2005	2006	2007	2008	2009	Thereafter
Avista Utilities:						
Long-term debt maturities (1).....	\$ 84	\$ 38	\$ 176	\$ 326	\$ -	\$ 352
Long-term debt to affiliated trusts (1)	-	-	-	-	-	113
Interest on debt (2).....	89	87	83	77	72	-
Short-term borrowings (3).....	68	-	-	-	-	-
Accounts receivable sales (4)	72	-	-	-	-	-
Preferred stock redemptions (1)	2	2	26	-	-	-
Energy purchase contracts (5)	270	143	151	141	136	750
Public Utility District contracts (5).....	4	3	3	3	3	20
Operating lease obligations (6).....	4	4	3	3	3	7
Capital lease obligations (6)	1	1	1	1	-	-
Other obligations (7).....	15	15	15	15	15	177
Information services contracts.....	12	12	11	11	11	32
Pension plan funding (9)	15	15	15	12	-	-
Avista Capital (consolidated):						
Long-term debt.....	-	-	-	-	-	7
Short-term borrowings.....	1	-	-	-	-	-
Energy purchase contracts (8)	650	283	179	191	180	523
Operating lease obligations (6).....	2	2	2	2	2	-
Capital lease obligations (6)	-	1	1	-	-	-
Total contractual obligations	\$1,289	\$606	\$666	\$782	\$422	\$1,981

- (1) For 2005, the Company expects that cash flows from operations and short-term debt will provide sufficient funds for maturing long-term debt and preferred stock redemptions, with the exception of the maturing \$54.6 million of debt for WP Funding LP, which the Company expects to refinance on a long-term basis. However, if market conditions warrant during 2005, the Company may issue long-term debt to fund these obligations and potentially repurchase long-term debt scheduled to mature in future years to reduce its overall debt service costs. In years subsequent to 2005, the Company will most likely need to issue additional long-term debt to fund these obligations.
- (2) Represents the Company's estimate of interest payments on debt. The Company will make interest payments beyond 2009; however, the Company has not made an estimate of such payments at this time.
- (3) Represents \$68 million outstanding under a \$350 million five-year revolving line of credit. Although the Company is not contractually obligated to repay the amount borrowed until 2009, it is expected that borrowings outstanding as of December 31, 2004 will be repaid in 2005. However, additional borrowings will be made on the revolving line of credit during 2005 as well.
- (4) Represents \$72 million outstanding under a revolving \$85 million accounts receivable sales financing facility.
- (5) Energy purchase contracts were entered into as part of Avista Utilities' obligation to serve its retail natural gas and electric customers' energy requirements. As a result, these costs are generally recovered either through base retail rates or adjustments to retail rates as part of the power and natural gas cost adjustment mechanisms.
- (6) Includes the interest component of the lease obligation.
- (7) Represents operational agreements, settlements and other contractual obligations with respect to generation, transmission and distribution facilities. These costs are generally recovered through base retail rates.

- (8) Represents Avista Energy's contractual commitments to purchase energy commodities as well as commitments related to transmission, transportation and other energy-related contracts in future periods. Avista Energy also has sales commitments related to these contractual obligations in future periods.
- (9) Represents the Company's estimated cash contributions to the pension plan through 2008. The Company cannot reasonably estimate pension plan contributions beyond 2008 at this time.

As of December 31, 2004, Avista Corp. did not have any commitments outstanding with equity triggers. Avista Corp. does not expect any material impact from rating triggers; although there are certain rating triggers for Avista Corp. primarily related to changes in pricing under certain financing agreements. A reduction in the credit rating of Avista Corp. would represent an event of default under Avista Energy's credit agreement.

Competition

Avista Utilities competes with various rural electric cooperatives and public utility districts in and adjacent to its service territories in the provision of service to new retail electric customers. Alternate providers of power may also compete for sales to existing customers, including the potential for future market entrants as a result of deregulation. Competition for available electric resources can be critical to utilities as surplus power resources are absorbed by load growth. Avista Utilities' natural gas distribution operations compete with other energy sources; however, natural gas continues to maintain a price advantage compared to heating oil, propane and other fuels, provided that the natural gas distribution system is proximate to prospective customers.

The Energy Policy Act of 1992 (Energy Act) amended provisions of the Public Utility Holding Company Act of 1935 (PUHCA) and the Federal Power Act to remove certain barriers to a competitive wholesale market. The Energy Act expanded the authority of the FERC to issue orders requiring electric utilities to transmit power and energy to or for wholesale purchasers and sellers, and to require electric utilities to enlarge or construct additional transmission capacity for the purpose of providing these services. It also created "exempt wholesale generators," a class of independent power plant owners that are able to sell generation only at the wholesale level. This permits public utilities and other entities to participate through subsidiaries in the development of independent electric generating plants for sales to wholesale customers without being required to register under the PUHCA.

Participants in the wholesale market include other utilities, federal power marketing agencies, energy marketing and trading companies, and independent power producers. The electric wholesale market continues to change with respect to the number and types of market participants involved, volume of buying and selling activity, price volatility, market liquidity, regulatory initiatives and challenges in regulatory and legal arenas, and credit strength by market participants. Starting in 2000 and the first half of 2001, the electric wholesale market in the WECC region was marked by significant volatility, service disruptions and defaults by certain participants. During the second half of 2001 and 2002, wholesale market prices decreased to levels similar to those experienced before 2000. Wholesale market prices increased in 2003 and 2004 compared to 2002; however, prices have not increased to levels experienced during 2000 and the first half of 2001. Although market conditions generally improved during 2004, many energy companies are facing liquidity issues, and counterparty credit exposure is of concern to market participants. Multiple legal and regulatory challenges have been initiated particularly with respect to the turbulence of 2000 and 2001; several of these legal and regulatory matters remain unresolved (see "Note 25 of the Notes to Consolidated Financial Statements"). Avista Corp. actively monitors and participates as appropriate in energy industry developments to maintain and enhance its ability to effectively participate in electric wholesale markets consistent with its business goals.

The subsidiaries in the non-energy businesses, particularly Avista Advantage, are subject to competition as they develop products and services and enter new markets. It is also a challenge for Avista Advantage to maintain its current customer base. Competition from other companies in these non-energy businesses may mean challenges for a company to be the first to market a new product or service to gain the advantage in market share. Challenges for these businesses include the availability of funding and resources to meet capital needs, rapidly advancing technologies, possibly making some of the current technology quickly obsolete, and requiring continual product enhancement.

Business Risk

The Company's operations are exposed to risks including, but not limited to, the price and supply of purchased power, fuel and natural gas, regulatory allowance of the recovery of power and natural gas costs, operating costs and capital investments, streamflow and weather conditions, the effects of changes in legislative and governmental regulations, changes in regulatory requirements, availability of generation facilities, competition, technology and availability of

funding. Also, like other utilities, the Company's facilities and operations may be exposed to terrorism risks or other malicious acts. See further reference to risks and uncertainties under "Forward-Looking Statements."

Avista Utilities has mechanisms in each regulatory jurisdiction, which provide for the recovery of the majority of the changes in its power and natural gas costs. The majority of power and natural gas costs that exceed the amount currently recovered through retail rates, excluding the \$9.0 million threshold for power costs in Washington, are deferred on the Consolidated Balance Sheets for the opportunity of recovery through future retail rates. These deferred power and natural gas costs are subject to review for prudence and recoverability and as such certain deferred costs may be disallowed by the respective regulatory agencies.

Hydroelectric generation was 95 percent of normal in 2004 and 89 percent of normal in 2003. Forecasts as of March 1, 2005 indicate that hydroelectric generation will be approximately 84 percent of normal in 2005 assuming normal precipitation for the remainder of the year. This forecast may change based upon precipitation, temperatures and other variables. The earnings impact of these factors is mitigated by regulatory mechanisms that are intended to defer increased power supply costs for recovery in future periods. Avista Utilities is not able to predict how the combination of energy resources, energy loads, prices, rate recovery and other factors will ultimately drive deferred power costs and the timing of recovery of these costs in future periods. See further information at "Avista Utilities - Regulatory Matters."

Challenges facing Avista Utilities' electric operations include, among other things, the timing and approval of the recovery of deferred power costs, changes in the availability of and volatility in the prices of power and fuel, generating unit availability, legislative and governmental regulations, potential tax law changes, customer response to price increases and surcharges, streamflows and weather conditions.

During recent years, natural gas prices have been volatile with a general upward trend. Avista Utilities' average prices per dekatherm were \$6.62, \$5.50 and \$4.95 in 2004, 2003 and 2002, respectively. Market prices for natural gas continue to be competitive compared to alternative fuel sources for residential, commercial and industrial customers. Avista Utilities believes that natural gas should sustain its market advantage over competing energy sources based on the levels of existing reserves and the potential for natural gas development in the future. Growth has occurred in the natural gas business in recent years due to increased demand for natural gas in new construction, as well as conversions from competing space and water heating energy sources to natural gas.

Challenges facing Avista Utilities' natural gas operations include, among other things, volatility in the price of natural gas, changes in the availability of natural gas, legislative and governmental regulations, weather conditions and the timing and approval of recovery for increased commodity costs. Avista Utilities' natural gas business also faces the potential for certain natural gas customers to by-pass its natural gas system. To reduce the potential for such by-pass, Avista Utilities prices its natural gas services, including transportation contracts, competitively and has varying degrees of flexibility to price its transportation and delivery rates by means of individual contracts, subject to state regulatory review and approval. Avista Utilities has long-term transportation contracts with several of its largest industrial customers, which reduces the risk of these customers by-passing the system in the foreseeable future.

In addition to its asset management activities, Avista Energy trades electricity and natural gas, along with derivative commodity instruments, including futures, options, swaps and other contractual arrangements. As a result of these trading activities, Avista Energy is subject to various risks including commodity price risk and credit risk, as well as possible risks resulting from the imposition of market controls by federal and state agencies. The FERC is conducting proceedings and investigations related to market controls within the western United States that include proposals by certain parties to impose refunds. As a result, certain parties have asserted claims for significant refunds from Avista Energy and lesser refunds from Avista Utilities, which could result in liabilities for refunding revenues recognized in prior periods. Avista Energy and Avista Utilities have joined other parties in opposing these proposals. The refund proceedings provide that any refunds owed could be offset against unpaid energy debts due to the same party. As of December 31, 2004, Avista Energy's accounts receivable outstanding related to defaulting parties in California are fully offset by reserves for uncollected amounts and funds collected from defaulting parties. Avista Energy is pursuing recovery of the defaulted obligations. See "Counterparty Defaults," "California Refund Proceeding" and "Pacific Northwest Refund Proceeding" in "Note 25 of the Notes to Consolidated Financial Statements" for further information with respect to the refund proceedings.

In connection with matching loads to available resources and optimizing the use of its assets, Avista Utilities engages in wholesale sales and purchases of electric capacity and energy and, accordingly, is also subject to commodity price risk, credit risk and other risks associated with these activities.

Commodity Price Risk. Both Avista Utilities and Avista Energy are subject to energy commodity price risk. Price risk is, in general, the risk of fluctuation in the market price of the commodity needed, held or traded. The price of energy in wholesale markets is affected primarily by fundamental factors related to production costs and by other factors including weather and the resulting retail loads. In the case of electricity, prices can be affected by the adequacy of generating reserve margins, scheduled and unscheduled outages of generating facilities, availability of streamflows for hydroelectric generation, the price of thermal generating plant fuel, and disruptions or constraints to transmission facilities, among other things. Natural gas prices are affected by a number of factors, including, but not limited to, the adequacy of North American production, the level of imports, the level of inventories, global energy markets, and the availability of pipeline capacity to transport natural gas from region to region. In addition, oil prices can influence natural gas prices, because of fuel-switching capabilities of certain energy users. Demand changes caused by variations in the weather and other factors can also affect market prices. Any combination of these factors that results in a shortage of energy generally causes the market price of power to move upward. In addition to these factors, wholesale power markets are subject to regulatory constraints including price controls. The FERC imposed a price mitigation plan in the western United States in June 2001 and has subsequently modified various price and market control regulations.

Price risk also includes the risk of fluctuation in the market price of associated derivative commodity instruments (such as options and forward contracts). Price risk may also be influenced to the extent that the performance or non-performance by market participants of their contractual obligations and commitments affect the supply of, or demand for, the commodity.

Wholesale market prices for power and natural gas in the western United States and western Canada were significantly higher in 2000 and the first half of 2001 than at any time in history, with unprecedented levels of volatility. Prices and volatility decreased considerably since the second half of 2001 relative to 2000 and the first half of 2001.

Credit Risk. Credit risk relates to the risk of loss that Avista Utilities and/or Avista Energy would incur as a result of non-performance by counterparties of their contractual obligations to deliver energy or make financial settlements. Avista Utilities and Avista Energy often extend credit to counterparties and customers. Credit risk includes the risk that a counterparty may default due to circumstances relating directly to it and the risk that a counterparty may default due to circumstances that relate to other market participants that have a direct or indirect relationship with such counterparty. Should a counterparty, customer or supplier fail to perform, Avista Utilities or Avista Energy may be required to replace existing contracts with contracts at then-current market prices or to honor the underlying commitment.

Avista Utilities and Avista Energy seek to mitigate credit risk by applying specific eligibility criteria to existing and prospective counterparties and by actively monitoring current credit exposures. These policies include an evaluation of the financial condition and credit ratings of counterparties, collateral requirements or other credit enhancements, such as letters of credit or parent company guarantees, and the use of standardized agreements that allow for the netting or offsetting of positive and negative exposures associated with a single counterparty. However, despite mitigation efforts, defaults by counterparties periodically occur. Avista Energy experienced payment receipt defaults from certain parties impacted by the California energy crisis. Both Avista Corp. and Avista Energy engaged in considerable business and had short-term and long-term contracts with entities that have filed for bankruptcy protection. These bankruptcies and other changes, uncertainties and regulatory proceedings have resulted in reduced liquidity in the energy markets.

A trend of declining credit quality was evident during 2002 and continued into 2003 and 2004, particularly throughout the energy industry. Rating agencies have downgraded the credit ratings of several of the counterparties of Avista Energy and Avista Utilities. Avista Energy and Avista Utilities regularly evaluate counterparties' credit exposure for future settlements and delivery obligations. Avista Energy and Avista Utilities have taken a conservative position by reducing or eliminating open (unsecured) credit limits and implemented other credit risk reduction measures for parties perceived to have increased default risk. Counterparty collateral is used to offset the Company's credit risk where unsettled net positions and future obligations by counterparties to pay Avista Utilities and/or Avista Energy or deliver to Avista Utilities and/or Avista Energy warrant.

Avista Energy has concentrations of suppliers and customers in the electric and natural gas industries including electric utilities, natural gas distribution companies, and other energy marketing and trading companies. In addition, Avista Energy has concentrations of credit risk related to geographic location, as Avista Energy operates in the western United States and western Canada. These concentrations of counterparties and concentrations of geographic location may impact Avista Energy's overall exposure to credit risk, either positively or negatively, because the counterparties may be similarly affected by changes in economic, regulatory or other conditions.

Credit risk also involves the exposure that counterparties perceive related to the ability of Avista Utilities and Avista Energy to perform deliveries and settlement under physical and financial energy contracts. These counterparties may seek assurances of performance in the form of letters of credit, prepayment or cash deposits and, in the case of Avista Energy, parent company (Avista Capital) performance guarantees. In periods of price volatility, the level of exposure can change significantly, with the result that sudden and significant demands may be made against the Company's capital resource reserves (credit facilities and cash). Avista Utilities and Avista Energy actively monitor the exposure to possible collateral calls and take steps to minimize capital requirements.

In conjunction with the valuation of their commodity derivative instruments and accounts receivable, Avista Utilities and Avista Energy maintain credit reserves that are based on management's evaluation of the credit risk of the overall portfolio. Based on these policies, exposures and credit reserves, the Company does not anticipate a materially adverse effect on its financial condition or results of operations as a result of counterparty nonperformance.

Other Operating Risks. In addition to commodity price risk, Avista Utilities' commodity positions are subject to operational and event risks including, among others, increases in load demand, transmission or transport disruptions, fuel quality specifications, changes in regulatory requirements, forced outages at generating plants and disruptions to information systems and other administrative tools required for normal operations. Avista Utilities also has exposure to weather conditions and natural disasters that can cause physical damage to property, requiring repairs to restore utility service. The emergence of terrorism threats, both domestic and foreign, is a risk to the entire utility industry, including Avista Utilities. Potential disruptions to operations or destruction of facilities from terrorism or other malicious acts are not readily determinable. The Company has taken various steps to mitigate terrorism risks and to prepare contingency plans in the event that its facilities are targeted.

Interest Rate Risk. The Company is subject to the risk of fluctuating interest rates in the normal course of business. The Company manages interest rate risk by taking advantage of market conditions when timing the issuance of long-term financings and optional debt redemptions and through the use of fixed rate long-term debt with varying maturities. The interest rate on \$51.5 million of long-term debt to affiliated trusts is adjusted quarterly, reflecting current market conditions. Additionally, amounts borrowed under the Company's \$350.0 million five-year committed line of credit have a variable interest rate.

In 2004, Avista Corp. entered into three forward-starting interest rate swap agreements, totaling \$200.0 million, to manage the risk that changes in interest rates may affect the amount of future interest payments. These interest rate swap agreements relate to the anticipated issuances of debt to fund maturing debt in 2007 and 2008. Under the terms of these agreements, the value of the interest rate swaps are determined based upon Avista Corp. paying a fixed rate and receiving a variable rate based on LIBOR. These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. As of December 31, 2004, Avista Corp. had a derivative liability of \$6.5 million and provided cash collateral of \$0.6 million to the interest rate swap counterparties related to these interest rate swaps. The Company estimates that a 10 basis point increase in forward LIBOR interest rates as of December 31, 2004 would have decreased this derivative liability by approximately \$1.3 million, while a 10 basis point decrease would have increased the liability by approximately \$1.3 million.

Foreign Currency Risk. Avista Energy has investments in Canadian companies through Avista Energy Canada and its subsidiary, CoPac Management, Inc. In addition, Avista Energy enters into Canadian dollar denominated transactions in Canada for gas commodity and related services. These transactions in aggregate expose Avista Energy to foreign currency risk. Avista Energy attempts to limit its exposure to changing foreign exchange rates through both operational and financial market actions. This includes entering into forward and swap contracts to hedge existing exposures, firm commitments and anticipated transactions. These arrangements are carried at fair value and were not significant as of December 31, 2004. Also, Avista Utilities will begin to have foreign currency risk as natural gas procurement operations are implemented. This is not expected to have a material effect on Avista Utilities' financial condition, results of operations or cash flows.

Risk Management

Risk Policies and Oversight. Avista Utilities and Avista Energy use a variety of techniques to manage risks for their energy resources and wholesale energy market activities. The Company has risk management policies and procedures to manage these risks, both qualitative and quantitative, for Avista Utilities and Avista Energy. The Company's Risk Management Committee establishes the Company's risk management policies and procedures and monitors compliance. The Risk Management Committee is comprised of certain Company officers and other individuals and is

overseen by the Audit Committee of the Company's Board of Directors. The Company's Risk Management Committee reviews the status of risk exposures through regular reports and meetings and it monitors compliance with the Company's risk management policies and procedures on a regular basis. Nonetheless, adverse changes in commodity prices, generating capacity, customer loads, regulation and other factors may result in losses in earnings, cash flows and/or fair values.

Avista Utilities and Avista Energy also operate with a wholesale energy markets credit policy. The credit policy is designed to reduce the risk of financial loss in case counterparties default on delivery or settlement obligations and to conserve the Company's liquidity as other parties may place credit limits or require collateral.

Quantitative Risk Measurements. Avista Utilities measures the monthly, quarterly and annual energy volume of its imbalance between projected power loads and resources. Normal operations result in seasonal mismatches between power loads and available resources. Avista Utilities is able to vary the operation of its generating resources to match parts of its hourly, daily and weekly load fluctuations. Avista Utilities uses the wholesale power markets to sell projected resource surpluses and obtain resources when deficits are projected. Avista Utilities buys and sells fuel for thermal generation facilities based on comparative power market prices and marginal costs of fueling and operating its available generating facilities.

Load/resource imbalances within a rolling 18-month planning horizon are compared against established volumetric guidelines and management determines the timing and specific actions to manage the imbalances. Management also assesses available resource decisions and actions that are appropriate for longer-term planning periods. Expected load and resource volumes for forward periods are based on monthly and quarterly averages that may vary materially from the actual loads and resources within any individual month or operating day. Future projections of resources are updated as forecasted streamflows and other factors differ from prior estimates. Forward power markets may be illiquid, and market products available may not match Avista Utilities' desired transaction size and shape. Therefore, open imbalance positions exist at any given time.

Avista Utilities' natural gas loads and resources are regularly reviewed by operating management and the Risk Management Committee. The balancing of loads and resources is accomplished through commodity purchases and the use of natural gas storage facilities owned by, or contracted with, Avista Utilities. Timing, pricing and volume decisions are subject to the Avista Utilities' hedging practices that include a cross-departmental oversight group.

Avista Energy measures the risk in its electric and natural gas portfolio daily utilizing a Value-at-Risk (VAR) model, which monitors its risk in comparison to established thresholds. VAR measures the expected portfolio loss under hypothetical adverse price movements, over a given time interval within a given confidence level. The VAR computations utilize historical price movements over a specified period to simulate forward price curves in the energy markets and estimate the potential unfavorable impact of price movement in the portfolio of transactions scheduled to settle within the following eight calendar quarters. The quantification of market risk using VAR provides a consistent measure of risk across Avista Energy's continually changing portfolio. VAR represents an estimate of reasonably possible net losses in earnings that would be recognized on its portfolio assuming hypothetical movements in future market rates and is not necessarily indicative of actual results that may occur. Avista Energy's VAR computations utilize several key assumptions, including a 95 percent confidence level for the resultant price movement and holding periods of one and three days. The calculation includes derivative commodity instruments held for trading purposes and excludes the effects of embedded physical options in the trading portfolio. For forward transactions that settle beyond the next eight calendar quarters, Avista Energy applies other risk measurement techniques, including price sensitivity stress tests, to assess the future market risk. Volatility in longer-dated forward markets tends to be significantly less than in near-term markets. Avista Energy also measures its open positions in terms of volumes at each delivery location for each forward time period. The permissible extent of open positions is included in the risk management policy and is measured with stress tests and VAR modeling.

As of December 31, 2004, Avista Energy's estimated potential one-day unfavorable impact on gross margin as measured by VAR was \$0.4 million, compared to \$0.7 million as of December 31, 2003. The average daily VAR for 2004 was \$0.5 million. The high daily VAR was \$0.8 million and the low daily VAR was \$0.4 million during 2004. Avista Energy was in compliance with its one-day VAR limits during 2004. Changes in markets inconsistent with historical trends or assumptions used could cause actual results to exceed predicted limits.

As of December 31, 2004, 88 percent of Avista Corp.'s credit exposure was to investment grade counterparties or noninvestment grade counterparties whose exposure was mitigated by collateral posted to Avista Corp. Of the remaining unmitigated exposure to non-investment grade counterparties, 10 percent represents settlements that were made within thirty days after December 31, 2004.

As of December 31, 2004, 94 percent of Avista Energy's credit exposure was to investment grade counterparties or noninvestment grade counterparties whose exposure was mitigated through collateral posted to Avista Energy. Of the remaining unmitigated exposure to non-investment grade counterparties, approximately 84 percent represents settlements that were made within thirty days after December 31, 2004.

Economic and Load Growth

Avista Utilities, along with others in the service area, encourages regional economic development, including expanding existing businesses and attracting new businesses to the Inland Northwest region. Agriculture, mining and lumber were the primary industries for many years; today health care, education, finance, electronic and other manufacturing, tourism and the service sectors are growing in importance in Avista Utilities' service area. Avista Utilities anticipates moderate economic growth to continue throughout its service area.

Avista Utilities anticipates retail electric load growth to average between 2.0 and 3.0 percent annually for the next four years, primarily due to expected population increases and business growth in its service territory. While the number of electric customers is expected to increase, the average annual usage by each residential customer is not expected to change significantly. For the next four years, Avista Utilities expects natural gas load growth to average between 4.0 and 4.5 percent annually in its Washington and Idaho service territory and 2.5 and 3.0 percent in its Oregon service territory. The natural gas load growth is primarily expected through conversions to natural gas from competing space and water heating energy sources, and population increases and business growth in Avista Utilities' service territories. Natural gas loads for space heating vary significantly with annual fluctuations in weather within Avista Utilities' service territories.

The forward-looking projections set forth above regarding retail sales growth are based, in part, upon purchased economic forecasts and publicly available population and demographic studies. The expectations regarding retail sales growth are also based upon various assumptions, including, without limitation, assumptions relating to weather and economic and competitive conditions, internal analysis of company-specific data, such as energy consumption patterns and internal business plans, and an assumption that Avista Utilities will incur no material loss of retail customers due to self-generation or retail wheeling. Changes in actual experience can vary significantly from forward-looking projections.

Management Succession and Employee Issues

Protecting the Company's culture, mission, and long-term strategy by having a strong succession planning and management development process is one of the key strategic initiatives at Avista Corp. The Company's executive officer team continues to work towards ensuring that an effective succession planning process is in place for the best interests of the Company's future. The Company has implemented bench strength analysis in its management group as well as in key technical and craft areas. The focus is on organizational leadership capability as well as technical proficiency in complex jobs. The Company has implemented development plans for its future successors that identify areas of strengths and weaknesses. Development plans provide action steps that provide new opportunities to work towards ensuring that successor candidates have the needed experience for running the Company. The Company believes that its succession planning process is providing the right structure to assure that the Company has the ability to fill vacancies with personnel having adequate training and experience.

Environmental Issues and Other Contingencies

See "Note 25 of the Notes to Consolidated Financial Statements."

Quantitative and Qualitative Disclosures About Market Risk

See "Management's Discussion and Analysis of Financial Condition and Results of Operations: – Business Risk and – Risk Management," "Management's Discussion and Analysis of Financial Condition and Results of Operations – Energy Marketing and Resource Management – Energy trading activities and positions," "Note 7 of the Notes to Consolidated Financial Statements" and "Note 21 of the Notes to Consolidated Financial Statements."

CONSOLIDATED STATEMENTS OF INCOME

Avista Corporation

For the Years Ended December 31

Dollars in thousands, except per share amounts

	2004	2003	2002
OPERATING REVENUES.....	\$1,151,580	\$1,123,385	\$1,062,916
OPERATING EXPENSES:			
Resource costs.....	604,984	576,492	536,714
Operations and maintenance.....	155,944	138,058	125,930
Administrative and general.....	104,266	97,494	105,647
Depreciation and amortization.....	78,425	77,811	71,867
Taxes other than income taxes.....	67,491	61,827	65,616
Total operating expenses.....	1,011,110	951,682	905,774
INCOME FROM OPERATIONS.....	140,470	171,703	157,142
OTHER INCOME (EXPENSE):			
Interest expense.....	(87,265)	(91,505)	(104,866)
Interest expense to affiliated trusts.....	(5,782)	(1,480)	-
Capitalized interest.....	1,393	1,092	7,486
Net interest expense.....	(91,654)	(91,893)	(97,380)
Other income - net.....	8,390	6,173	17,261
Total other income (expense)-net.....	(83,264)	(85,720)	(80,119)
INCOME FROM CONTINUING OPERATIONS			
BEFORE INCOME TAXES.....	57,206	85,983	77,023
INCOME TAXES.....	21,592	35,340	34,849
INCOME FROM CONTINUING OPERATIONS.....	35,614	50,643	42,174
DISCONTINUED OPERATIONS (Note 3):			
Loss before asset impairment charges,			
minority interest and income taxes.....	-	(4,029)	(10,461)
Asset impairment charges.....	-	(3,905)	-
Minority interest.....	-	-	241
Income tax benefit.....	-	2,985	3,501
LOSS FROM DISCONTINUED OPERATIONS.....	-	(4,949)	(6,719)
NET INCOME BEFORE CUMULATIVE			
EFFECT OF ACCOUNTING CHANGE.....	35,614	45,694	35,455
CUMULATIVE EFFECT OF ACCOUNTING CHANGE (net of tax).....	(460)	(1,190)	(4,148)
NET INCOME.....	35,154	44,504	31,307
DEDUCT-Preferred stock dividend requirements.....	-	1,125	2,402
INCOME AVAILABLE FOR COMMON STOCK.....	\$ 35,154	\$ 43,379	\$ 28,905
Weighted-average common shares outstanding (thousands), Basic.....	48,400	48,232	47,823
Weighted-average common shares outstanding (thousands), Diluted.....	48,886	48,630	47,874
EARNINGS PER COMMON SHARE, BASIC (Note 23):			
Earnings per common share from continuing operations.....	\$ 0.74	\$ 1.03	\$ 0.83
Loss per common share from discontinued operations.....	-	(0.10)	(0.14)
Earnings per common share before			
cumulative effect of accounting change.....	0.74	0.93	0.69
Loss per common share from			
cumulative effect of accounting change.....	(0.01)	(0.03)	(0.09)
Total earnings per common share, basic.....	\$ 0.73	\$ 0.90	\$ 0.60
EARNINGS PER COMMON SHARE, DILUTED (Note 23):			
Earnings per common share from continuing operations.....	\$ 0.73	\$ 1.02	\$ 0.83
Loss per common share from discontinued operations.....	-	(0.10)	(0.14)
Earnings per common share before			
cumulative effect of accounting change.....	0.73	0.92	0.69
Loss per common share from			
cumulative effect of accounting change.....	(0.01)	(0.03)	(0.09)
Total earnings per common share, diluted.....	\$ 0.72	\$ 0.89	\$ 0.60
Dividends paid per common share.....	\$ 0.515	\$ 0.490	\$ 0.480

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Avista Corporation

For the Years Ended December 31

Dollars in thousands

	2004	2003	2002
NET INCOME.....	\$35,154	\$44,504	\$31,307
OTHER COMPREHENSIVE INCOME (LOSS):			
Foreign currency translation adjustment.....	493	931	8
Unrealized gains (losses) on interest rate swap agreements - net of taxes of \$(1,969), \$51 and \$(677), respectively.....	(3,656)	94	(1,258)
Unfunded accumulated benefit obligation - net of taxes of \$(4,086), \$5,097 and \$(9,736), respectively.....	(7,589)	9,466	(18,081)
Unrealized gains (losses) on derivative commodity instruments - net of taxes of \$(681) and \$1,245, respectively.....	(1,264)	2,313	-
Reclassification adjustment for realized gains on derivative commodity instruments included in net income - net of taxes of \$(257) and \$(258), respectively.....	(477)	(480)	-
Unrealized investment losses - net of taxes of \$(655).....	-	-	(1,217)
Reclassification adjustment for net realized losses on investments - net of taxes of \$152.....	-	-	283
TOTAL OTHER COMPREHENSIVE INCOME (LOSS).....	(12,493)	12,324	(20,265)
COMPREHENSIVE INCOME.....	\$ 22,661	\$ 56,828	\$ 11,042

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED BALANCE SHEETS

Avista Corporation

As of December 31

Dollars in thousands

	2004	2003
ASSETS:		
CURRENT ASSETS:		
Cash and cash equivalents.....	\$88,317	\$128,126
Restricted cash.....	26,175	16,472
Securities held for trading.....	-	18,903
Accounts and notes receivable-less allowances of \$44,193 and \$46,382, respectively.....	325,755	318,848
Energy commodity assets.....	284,231	253,676
Materials and supplies, fuel stock and natural gas stored.....	26,108	22,428
Deferred income taxes.....	12,288	11,455
Assets held for sale.....	28,479	-
Other current assets.....	108,989	93,671
Total current assets.....	<u>900,342</u>	<u>863,579</u>
NET UTILITY PROPERTY:		
Utility plant in service.....	2,666,445	2,606,012
Construction work in progress.....	51,260	49,615
Total.....	<u>2,717,705</u>	<u>2,655,627</u>
Less: Accumulated depreciation and amortization.....	<u>761,642</u>	<u>741,626</u>
Total net utility property.....	<u>1,956,063</u>	<u>1,914,001</u>
OTHER PROPERTY AND INVESTMENTS:		
Investment in exchange power-net.....	35,933	38,383
Non-utility properties and investments-net.....	78,564	89,133
Non-current energy commodity assets.....	254,657	242,359
Investment in affiliated trusts.....	13,403	13,403
Other property and investments-net.....	<u>19,721</u>	<u>17,958</u>
Total other property and investments.....	<u>402,278</u>	<u>401,236</u>
DEFERRED CHARGES:		
Regulatory assets for deferred income tax.....	123,159	131,763
Other regulatory assets.....	39,044	44,381
Non-current utility energy commodity derivative assets.....	55,825	34,517
Power and natural gas deferrals.....	148,206	171,342
Unamortized debt expense.....	53,413	48,825
Other deferred charges.....	<u>25,493</u>	<u>30,431</u>
Total deferred charges.....	<u>445,140</u>	<u>461,259</u>
TOTAL ASSETS.....	<u><u>\$3,703,823</u></u>	<u><u>\$3,640,075</u></u>

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED BALANCE SHEETS (continued)

Avista Corporation

As of December 31

Dollars in thousands

	2004	2003
LIABILITIES AND STOCKHOLDERS' EQUITY:		
CURRENT LIABILITIES:		
Accounts payable.....	\$325,194	\$298,285
Energy commodity liabilities.....	253,527	229,642
Deposits from counterparties.....	6,015	97,811
Current portion of long-term debt.....	85,432	29,711
Current portion of preferred stock-cumulative (17,500 shares outstanding).....	1,750	1,750
Short-term borrowings.....	68,517	80,525
Interest accrued.....	18,632	18,504
Other current liabilities.....	114,973	96,324
Total current liabilities.....	874,040	852,552
LONG-TERM DEBT.....	901,556	925,012
LONG-TERM DEBT TO AFFILIATED TRUSTS.....	113,403	113,403
PREFERRED STOCK-CUMULATIVE (subject to mandatory redemption):		
10,000,000 shares authorized: \$6.95 Series K		
280,000 and 297,500 shares outstanding (\$100 stated value), respectively.....	28,000	29,750
OTHER NON-CURRENT LIABILITIES AND DEFERRED CREDITS:		
Non-current energy commodity liabilities.....	215,055	192,731
Regulatory liability for utility plant retirement costs.....	175,575	167,061
Non-current utility energy commodity derivative liabilities.....	33,490	33,060
Deferred income taxes.....	488,471	492,799
Other non-current liabilities and deferred credits.....	121,028	82,455
Total other non-current liabilities and deferred credits.....	1,033,619	968,106
TOTAL LIABILITIES.....	2,950,618	2,888,823
COMMITMENTS AND CONTINGENCIES (See Notes to Consolidated Financial Statements)		
STOCKHOLDERS' EQUITY:		
Common stock, no par value; 200,000,000 shares authorized;		
48,471,511 and 48,344,009 shares outstanding.....	629,056	626,788
Note receivable from employee stock ownership plan.....	(495)	(2,424)
Capital stock expense and other paid in capital.....	(10,677)	(10,950)
Accumulated other comprehensive loss.....	(20,533)	(8,040)
Retained earnings.....	155,854	145,878
TOTAL STOCKHOLDERS' EQUITY.....	753,205	751,252
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.....	\$3,703,823	\$3,640,075

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Increase (Decrease) in Cash and Cash Equivalents

Avista Corporation

For the Years Ended December 31

Dollars in thousands

	2004	2003	2002
CONTINUING OPERATING ACTIVITIES:			
Net income.....	\$ 35,154	\$ 44,504	\$ 31,307
Loss from discontinued operations.....	-	4,949	6,719
Cumulative effect of accounting change.....	460	1,190	4,148
Purchases of securities held for trading.....	(15,260)	(18,865)	-
Sales of securities held for trading.....	34,192	-	-
Non-cash items included in net income:			
Depreciation and amortization.....	78,425	77,811	71,867
Provision for deferred income taxes.....	19,168	28,395	(40,287)
Power and natural gas cost amortizations, net of deferrals.....	11,087	3,829	68,481
Amortization of debt expense.....	8,301	7,972	8,861
Write-offs and impairments of assets.....	21,990	4,900	-
Energy commodity assets and liabilities.....	678	22,128	87,403
Other.....	3,770	(11,214)	(10,763)
Changes in working capital components:			
Restricted cash.....	(9,703)	(3,489)	(11,783)
Sale of customer accounts receivable under revolving agreement-net.....	-	7,000	(10,000)
Accounts and notes receivable.....	(6,904)	(4,485)	80,342
Materials and supplies, fuel stock and natural gas stored.....	(4,023)	(682)	(717)
Other current assets.....	(10,102)	(15,251)	(21,906)
Accounts payable.....	26,909	(41,352)	(27,770)
Deposits from counterparties.....	(91,796)	5,137	76,954
Other current liabilities.....	5,996	10,087	14,004
NET CASH PROVIDED BY CONTINUING OPERATING ACTIVITIES.....	108,342	122,564	326,860
CONTINUING INVESTING ACTIVITIES:			
Utility property capital expenditures (excluding AFUDC).....	(115,346)	(102,271)	(64,207)
Other capital expenditures.....	(3,126)	(3,388)	(18,873)
Deposit for utility property acquisition.....	(5,000)	-	-
Changes in other property and investments.....	1,041	(5,724)	1,418
Repayments received on notes receivable.....	1,062	1,214	33,752
Proceeds from property sales and sale of subsidiary investments.....	2,466	549	586
Assets acquired and investments in subsidiaries.....	(524)	(229)	(461)
NET CASH USED IN CONTINUING INVESTING ACTIVITIES.....	(119,427)	(109,849)	(47,785)

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

Increase (Decrease) in Cash and Cash Equivalents

Avista Corporation

For the Years Ended December 31

Dollars in thousands

	2004	2003	2002
CONTINUING FINANCING ACTIVITIES:			
Increase (decrease) in short-term borrowings.....	\$(12,008)	\$ 50,525	\$(45,099)
Proceeds from issuance of long-term debt.....	89,761	44,795	621
Redemption and maturity of long-term debt.....	(66,857)	(124,859)	(204,014)
Proceeds from issuance of long-term debt to affiliated trusts.....	61,856	-	-
Redemption of long-term debt to affiliated trusts.....	(61,856)	-	-
Premiums paid for the redemption of long-term debt.....	(6,710)	(1,709)	(9,456)
Long-term debt and short-term borrowing issuance costs.....	(6,024)	(2,430)	(6,534)
Redemption of preferred stock.....	(1,750)	(1,575)	(1,750)
Issuance of common stock.....	4,061	5,497	7,035
Repurchase of subsidiary preferred stock.....	(4,285)	-	-
Cash dividends paid.....	(24,912)	(24,777)	(25,456)
NET CASH USED IN CONTINUING FINANCING ACTIVITIES.....	(28,724)	(54,533)	(284,653)
NET CASH USED IN CONTINUING OPERATIONS.....	(39,809)	(41,818)	(5,578)
NET CASH PROVIDED BY (USED IN) DISCONTINUED OPERATIONS.....	-	(3,342)	8,967
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS.....	(39,809)	(45,160)	3,389
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD.....	128,126	173,286	169,897
CASH AND CASH EQUIVALENTS AT END OF PERIOD.....	\$ 88,317	\$ 128,126	\$ 173,286
SUPPLEMENTAL CASH FLOW INFORMATION:			
Cash paid during the period:			
Interest.....	\$ 84,220	\$ 86,755	\$ 95,801
Income taxes.....	11,321	11,476	7,428
Non-cash financing and investing activities:			
Property and equipment purchased under capital leases.....	1,365	5,312	-
Unrealized gain (loss) on interest rate swap agreements.....	(5,625)	145	(1,936)
Intangible asset related to pension plan.....	(654)	(654)	6,366
Unfunded accumulated benefit obligation.....	(11,022)	15,198	(34,164)
Unrealized gain (loss) on derivative commodity instruments.....	(2,677)	2,819	-
Unrealized investment losses.....	-	-	(1,436)

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Avista Corporation

For the Years Ended December 31

Dollars in thousands

	Preferred Stock		Common Stock		Note Receivable from Employee Stock	Capital Stock Expense and Other Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
	Series K	Series L	Shares	Amount					
Balance as of December 31, 2001	350,000	\$ 35,000	47,632,678	\$ 617,737	\$	(11,924)	\$	\$ 120,028	\$ 755,063
Net income								31,307	31,307
Equity compensation plan transactions									
Employee Investment Plan (401-K)			2,730	74		(4)			70
Dividend Reinvestment Plan			227,585	3,046					3,046
Redemption of preferred stock	(17,500)	(1,750)	181,215	2,235					2,235
Repayments of note receivable					1,533				(1,750)
Other comprehensive loss							(20,265)		1,533
Cash dividends paid (common stock)								(22,955)	(20,265)
Cash dividends paid (preferred stock)								(2,402)	(22,955)
ESOP dividend tax savings								159	(2,402)
Balance as of December 31, 2002	332,500	\$ 33,250	48,044,208	\$ 623,092	\$	(11,928)	\$	\$ 126,137	\$ 746,041
Net income								44,504	44,504
Equity compensation plan transactions									
Employee Investment Plan (401-K)			130,603	(147)		219		(145)	(73)
Dividend Reinvestment Plan			169,198	1,462					1,462
Redemption of preferred stock	(17,500)	(1,750)		2,381		175			2,381
Repayments of note receivable					1,722				(1,575)
Other comprehensive income							12,324		1,722
Cash dividends paid (common stock)								(23,634)	12,324
Cash dividends paid (preferred stock)								(1,125)	(23,634)
ESOP dividend tax savings								141	(1,125)
Cumulative effect of accounting change	(315,000)	(31,500)				584			141
Balance as of December 31, 2003	-	-	48,344,009	\$ 626,788	\$	(10,950)	\$	\$ 145,878	(30,916)
Net income								35,154	\$ 751,252
Equity compensation plan transactions									35,154
Dividend Reinvestment Plan			127,502	316		273		(409)	180
Repayments of note receivable				1,952					1,952
Other comprehensive loss					1,929		(12,493)		1,929
Cash dividends paid (common stock)								(24,912)	(12,493)
ESOP dividend tax savings								143	(24,912)
Balance as of December 31, 2004	-	-	48,471,511	\$ 629,056	\$	(10,677)	\$	\$ 155,854	(143)
									\$ 753,205

The Accompanying Notes are an Integral Part of These Statements.

SCHEDULE OF INFORMATION BY BUSINESS SEGMENTS

Avista Corporation

For the Years Ended December 31

Dollars in thousands

	2004	2003	2002
OPERATING REVENUES:			
Avista Utilities.....	\$972,574	\$928,211	\$893,964
Energy Marketing and Resource Management.....	275,646	307,141	222,634
Avista Advantage.....	23,444	19,839	16,911
Other.....	17,127	13,581	14,645
Intersegment eliminations.....	(137,211)	(145,387)	(85,238)
Total operating revenues.....	<u>\$1,151,580</u>	<u>\$1,123,385</u>	<u>\$1,062,916</u>
RESOURCE COSTS:			
Avista Utilities.....	\$505,391	\$474,927	\$453,525
Energy Marketing and Resource Management.....	236,804	246,952	168,427
Intersegment eliminations.....	(137,211)	(145,387)	(85,238)
Total resource costs.....	<u>\$604,984</u>	<u>\$576,492</u>	<u>\$536,714</u>
GROSS MARGINS (operating revenues less resource costs):			
Avista Utilities.....	\$467,183	\$453,284	\$440,439
Energy Marketing and Resource Management.....	38,842	60,189	54,207
Total gross margins (operating revenues less resource costs).....	<u>\$506,025</u>	<u>\$513,473</u>	<u>\$494,646</u>
OPERATIONS AND MAINTENANCE EXPENSES:			
Avista Utilities.....	\$123,223	\$107,697	\$97,668
Energy Marketing and Resource Management.....	5,067	4,900	-
Avista Advantage.....	11,374	11,813	13,569
Other.....	16,280	13,648	14,693
Total operations and maintenance expenses.....	<u>\$155,944</u>	<u>\$138,058</u>	<u>\$125,930</u>
ADMINISTRATIVE AND GENERAL EXPENSES:			
Avista Utilities.....	\$70,806	\$65,951	\$63,751
Energy Marketing and Resource Management.....	19,676	22,950	21,820
Avista Advantage.....	8,426	6,705	6,736
Other.....	5,358	1,888	13,340
Total administrative and general expenses.....	<u>\$104,266</u>	<u>\$97,494</u>	<u>\$105,647</u>
DEPRECIATION AND AMORTIZATION EXPENSES:			
Avista Utilities.....	\$72,787	\$72,068	\$66,243
Energy Marketing and Resource Management.....	1,364	1,259	1,227
Avista Advantage.....	1,902	2,652	2,968
Other.....	2,372	1,832	1,429
Total depreciation and amortization expenses.....	<u>\$78,425</u>	<u>\$77,811</u>	<u>\$71,867</u>
INCOME FROM OPERATIONS:			
Avista Utilities.....	\$134,073	\$146,777	\$149,180
Energy Marketing and Resource Management.....	11,681	30,078	29,211
Avista Advantage.....	1,742	(1,331)	(6,363)
Other.....	(7,026)	(3,821)	(14,886)
Total income from operations.....	<u>\$140,470</u>	<u>\$171,703</u>	<u>\$157,142</u>

The Accompanying Notes are an Integral Part of These Statements.

SCHEDULE OF INFORMATION BY BUSINESS SEGMENTS (continued)

Avista Corporation

For the Years Ended December 31

Dollars in thousands

	2004	2003	2002
INTEREST EXPENSE (INCLUDING INTEREST EXPENSE TO AFFILIATED TRUSTS):			
Avista Utilities.....	\$92,068	\$91,908	\$103,597
Energy Marketing and Resource Management.....	528	1,009	7,126
Avista Advantage.....	874	742	763
Other.....	1,008	1,025	5,403
Intersegment eliminations.....	(1,431)	(1,699)	(12,023)
Total interest expense (including interest expense to affiliated trusts).....	<u>\$93,047</u>	<u>\$92,985</u>	<u>\$104,866</u>
INCOME TAXES:			
Avista Utilities.....	\$18,383	\$26,884	\$32,137
Energy Marketing and Resource Management.....	5,421	11,457	12,311
Avista Advantage.....	334	(718)	(2,289)
Other.....	(2,546)	(2,283)	(7,310)
Total income taxes.....	<u>\$21,592</u>	<u>\$35,340</u>	<u>\$34,849</u>
INCOME FROM CONTINUING OPERATIONS:			
Avista Utilities.....	\$32,467	\$36,241	\$36,382
Energy Marketing and Resource Management.....	9,733	20,672	22,425
Avista Advantage.....	577	(1,334)	(4,253)
Other.....	(7,163)	(4,936)	(12,380)
Total income from continuing operations.....	<u>\$35,614</u>	<u>\$50,643</u>	<u>\$42,174</u>
ASSETS:			
Avista Utilities.....	\$2,600,357	\$2,532,936	\$2,369,418
Energy Marketing and Resource Management.....	1,002,843	1,013,213	1,349,626
Avista Advantage.....	47,318	45,621	31,733
Other.....	53,305	48,305	42,866
Discontinued Operations.....	-	-	5,900
Total assets.....	<u>\$3,703,823</u>	<u>\$3,640,075</u>	<u>\$3,799,543</u>
CAPITAL EXPENDITURES:			
Avista Utilities (excluding AFUDC).....	\$115,346	\$102,271	\$64,207
Energy Marketing and Resource Management.....	1,455	2,013	17,531
Avista Advantage.....	840	459	1,109
Other.....	831	916	233
Total capital expenditures.....	<u>\$118,472</u>	<u>\$105,659</u>	<u>\$83,080</u>

The Accompanying Notes are an Integral Part of These Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Avista Corporation (Avista Corp. or the Company) is an energy company engaged in the generation, transmission and distribution of energy as well as other energy-related businesses. Avista Utilities is an operating division of Avista Corp., comprising the regulated utility operations. Avista Utilities generates, transmits and distributes electricity in parts of eastern Washington and northern Idaho. In addition, Avista Utilities has electric generating facilities in western Montana and northern Oregon. Avista Utilities also provides natural gas distribution service in parts of eastern Washington, northern Idaho, northeast and southwest Oregon and in the South Lake Tahoe region of California. In July 2004, the Company entered into an agreement to sell its South Lake Tahoe natural gas distribution properties (see Note 27 for further information), which is subject to regulatory approval. Avista Capital, a wholly owned subsidiary of Avista Corp., is the parent company of all of the subsidiary companies in the non-utility business segments.

The Company's operations are exposed to risks including, but not limited to, the price and supply of purchased power, fuel and natural gas, regulatory recovery of power and natural gas costs and capital investments, streamflow and weather conditions, the effects of changes in legislative and governmental regulations, changes in regulatory requirements, availability of generation facilities, competition, technology and availability of funding. Also, like other utilities, the Company's facilities and operations may be exposed to terrorism risks or other malicious acts. In addition, the energy business exposes the Company to the financial, liquidity, credit and commodity price risks associated with wholesale purchases and sales.

Basis of Reporting

The consolidated financial statements include the assets, liabilities, revenues and expenses of the Company and its subsidiaries. The accompanying financial statements include the Company's proportionate share of utility plant and related operations resulting from its interests in jointly owned plants (See Note 9).

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Significant estimates include determining unbilled revenues, the market value of energy commodity assets and liabilities, pension and other postretirement benefit plan obligations, contingent liabilities and recoverability of regulatory assets. Changes in these estimates and assumptions are considered reasonably possible and may have a material effect on the consolidated financial statements and thus actual results could differ from the amounts reported and disclosed herein.

System of Accounts

The accounting records of the Company's utility operations are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC) and adopted by the appropriate state regulatory commissions.

Regulation

The Company is subject to state regulation in Washington, Idaho, Montana, Oregon and California. The Company is also subject to federal regulation by the FERC.

Business Segments

Financial information for each of the Company's business segments is reported in the Schedule of Information by Business Segments. Such information is an integral part of these consolidated financial statements. The business segment presentation reflects the basis currently used by the Company's management to analyze performance and determine the allocation of resources. Avista Utilities' business is managed based on the total regulated utility operation. The Energy Marketing and Resource Management business segment primarily consists of electricity and natural gas marketing, trading and resource management including optimization of energy assets owned by other entities and derivative commodity instruments such as futures, options, swaps and other contractual arrangements. Avista Advantage is a provider of utility bill processing, payment and information services to multi-site customers throughout North America. The Other business segment includes other investments and operations of various subsidiaries as well as certain other operations of Avista Capital.

AVISTA CORPORATION

Avista Utilities Operating Revenues

Operating revenues for Avista Utilities related to the sale of energy are generally recorded when service is rendered or energy is delivered to customers. The determination of the energy sales to individual customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each calendar month, the amount of energy delivered to customers since the date of the last meter reading is estimated and the corresponding unbilled revenue is estimated and recorded. Accounts receivable includes unbilled energy revenues of \$13.0 million (net of \$48.9 million of unbilled receivables sold) and \$9.0 million (net of \$47.0 million of unbilled receivables sold) as of December 31, 2004 and 2003, respectively. See Note 5 for information with respect to the sale of accounts receivable.

Avista Energy Operating Revenues

Avista Energy follows Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138 and SFAS No. 149, with respect to the majority of its contracts. Avista Energy reports the net margin on derivative commodity instruments held for trading as operating revenues. Revenues from contracts that are not derivatives under SFAS No. 133, as well as derivative commodity instruments not held for trading, are reported on a gross basis in operating revenues. Revenues derived from Canadian contracts through Avista Energy Canada, which are not held for trading, and are reported on gross basis in operating revenues, totaled \$116.0 million, \$107.1 million and \$78.2 million in 2004, 2003 and 2002, respectively. During 2003, Avista Energy recorded as a cumulative effect of accounting change a charge of \$1.2 million (net of tax) related to Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which effectively required the transition of accounting for energy trading activities from EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" to SFAS No. 133.

Research and Development Expenses

Company-sponsored research and development expenditures are expensed as incurred. Research and development expenses did not exceed \$0.1 million for 2004 and totaled \$0.4 million and \$3.8 million in 2003 and 2002, respectively. The expenses for 2003 and 2002 primarily related to the activities of Avista Labs and are included in discontinued operations.

Advertising Expenses

The Company expenses advertising costs as incurred. Advertising expenses totaled \$1.9 million, \$1.4 million and \$1.3 million in 2004, 2003 and 2002, respectively.

Taxes other than income taxes

Taxes other than income taxes include state excise taxes, city occupational and franchise taxes, real and personal property taxes and certain other taxes not based on net income. These taxes are generally based on revenues or the value of property. Utility related taxes collected from customers are recorded as both operating revenue and expense and totaled \$35.0 million, \$31.7 million and \$33.1 million in 2004, 2003 and 2002, respectively.

Other Income-Net

Other income-net consisted of the following items for the years ended December 31 (dollars in thousands):

	2004	2003	2002
Interest income	\$4,313	\$4,810	\$7,716
Interest on power and natural gas deferrals	7,855	8,361	9,597
Net gain (loss) on the disposition of non-operating assets ..	785	(334)	(33)
Net gain (loss) on investments	434	(1,207)	2,084
Premium on repurchase of subsidiary preferred stock	(892)	-	-
Other expense	(6,854)	(7,063)	(6,570)
Other income	<u>2,749</u>	<u>1,606</u>	<u>4,467</u>
Total	<u>\$8,390</u>	<u>\$6,173</u>	<u>\$17,261</u>

Income Taxes

The Company and its eligible subsidiaries file consolidated federal income tax returns. Subsidiaries are charged or credited with the tax effects of their operations on a stand-alone basis. The Company's federal income tax returns were examined with all issues resolved, and all payments made, through the 2000 return. The Internal Revenue Service is currently examining the Company's 2001, 2002 and 2003 federal income tax returns.

AVISTA CORPORATION

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, a deferred tax asset or liability is determined based on the enacted tax rates that will be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's consolidated income tax returns. The deferred tax expense for the period is equal to the net change in the deferred tax asset and liability accounts from the beginning to the end of the period. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax liabilities and regulatory assets have been established for tax benefits flowed through to customers as prescribed by the respective regulatory commissions.

Stock-Based Compensation

The Company follows the disclosure only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." Accordingly, employee stock options are accounted for under Accounting Principle Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees." Stock options are granted at exercise prices not less than the fair value of common stock on the date of grant. Under APB No. 25, no compensation expense is recognized pursuant to the Company's stock option plans. See Note 2 with respect to the revision of SFAS No. 123, which will result in the recognition of compensation expense beginning in the third quarter of 2005.

If compensation expense for the Company's stock option plans were determined consistent with SFAS No. 123, net income and earnings per common share would have been the following pro forma amounts for the years ended December 31:

	2004	2003	2002
Net income (dollars in thousands):			
As reported	\$35,154	\$44,504	\$31,307
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of tax	<u>2,033</u>	<u>2,186</u>	<u>3,051</u>
Pro forma	<u>\$33,121</u>	<u>\$42,318</u>	<u>\$28,256</u>
Basic earnings per common share:			
As reported	\$0.73	\$0.90	\$0.60
Pro forma	\$0.68	\$0.85	\$0.54
Diluted earnings per common share:			
As reported	\$0.72	\$0.89	\$0.60
Pro forma	\$0.68	\$0.85	\$0.54

Comprehensive Income (Loss)

The Company's comprehensive income (loss), which is reported net of tax, is comprised of net income, foreign currency translation adjustments, changes in the unfunded accumulated benefit obligation for the pension plan, unrealized gains and losses on interest rate swap agreements, unrealized gains and losses on derivative commodity instruments and unrealized gains and losses on investments available-for-sale. Accumulated other comprehensive income (loss), net of tax, consisted of the following as of December 31 (dollars in thousands):

	2004	2003
Foreign currency translation adjustment	\$ 1,139	\$ 646
Unfunded accumulated benefit obligation for the pension plan	(16,944)	(9,355)
Unrealized loss on interest rate swap agreements	(4,820)	(1,164)
Unrealized gain on derivative commodity instruments	<u>92</u>	<u>1,833</u>
Total accumulated other comprehensive loss	<u>\$(20,533)</u>	<u>\$(8,040)</u>

Foreign Currency Translation Adjustment

The assets and liabilities of Avista Energy Canada, Ltd. and its subsidiary, CoPac Management, Inc., are denominated in Canadian dollars and translated to United States dollars at exchange rates in effect on the balance sheet date. Revenues and expenses are translated using an average exchange rate. Translation adjustments resulting from this process are reflected as a component of other comprehensive income (loss) in the Consolidated Statements of Comprehensive Income.

Earnings Per Common Share

Basic earnings per common share is computed by dividing income available for common stock by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing income available for common stock by diluted weighted average common shares outstanding during the period, including common stock equivalent shares outstanding using the treasury stock method, unless such shares

AVISTA CORPORATION

are anti-dilutive. Common stock equivalent shares include shares issuable upon exercise of stock options, contingently issuable shares and restricted stock. See Note 23 for earnings per common share calculations.

Cash and Cash Equivalents

For the purposes of the Consolidated Statements of Cash Flows, the Company considers all temporary investments with a maturity when purchased of three months or less to be cash equivalents. Cash and cash equivalents include cash deposits from counterparties. See Note 8 for further information with respect to cash deposits from counterparties.

Restricted Cash

Restricted cash includes bank deposits of \$21.5 million and \$15.0 million as collateral for letters of credit issued under Avista Energy's credit agreement as of December 31, 2004 and 2003, respectively. See Note 16 for further information with respect to Avista Energy's credit agreement. Restricted cash also includes deposits held in trust of \$1.6 million and \$1.5 million for certain employees of Avista Energy as part of a bonus retention plan as of December 31, 2004 and 2003, respectively. In addition, restricted cash as of December 31, 2004, includes \$2.5 million of deposits related to forward contracts at Avista Energy and \$0.6 million of deposits related to Avista Corp.'s interest rate swap agreements. See Note 17 for further information with respect to Avista Corp.'s interest rate swap agreements.

Securities held for trading

Securities held for trading represent the investment of cash held at Avista Energy in short-term instruments and are recorded at fair value on the Consolidated Balance Sheets with realized and unrealized gains and losses included in the Consolidated Statements of Income. Realized gains, realized losses and net unrealized gains were not material for 2004 and 2003. The Company did not have any securities held for trading as of December 31, 2004. The cost basis of such securities approximated the fair value of \$18.9 million as of December 31, 2003. The Company did not have any securities held for trading during 2002.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts to provide for estimated and potential losses on accounts receivable. The Company determines the allowance for utility and other customer accounts receivable based on historical write-offs as compared to accounts receivable and operating revenues. Additionally, the Company establishes specific allowances for certain individual accounts. The following table documents the activity in the allowance for doubtful accounts during the years ended December 31 (dollars in thousands):

	2004	2003	2002
Allowance as of the beginning of the year.....	\$46,382	\$46,909	\$50,211
Additions expensed during the year	3,367	1,912	3,469
Net deductions	(5,556)	(2,439)	(6,771)
Allowance as of the end of the year.....	<u>\$44,193</u>	<u>\$46,382</u>	<u>\$46,909</u>

Materials and supplies, fuel stock and natural gas stored

Inventories of materials and supplies, fuel stock and natural gas stored are recorded at the lower of cost or market, primarily using the average cost method.

Assets held for sale

Assets held for sale are recorded at the lower of cost or estimated fair value less selling costs. As of December 31, 2004, assets held for sale included \$15.2 million of assets related to Avista Utilities' South Lake Tahoe natural gas distribution properties and \$13.3 million of turbines and related equipment. Liabilities held for sale were not significant as of December 31, 2004.

Utility Plant in Service

The cost of additions to utility plant in service, including an allowance for funds used during construction and replacements of units of property and improvements, is capitalized. Costs of depreciable units of property retired plus costs of removal less salvage are charged to accumulated depreciation.

Allowance for Funds Used During Construction

The Allowance for Funds Used During Construction (AFUDC) represents the cost of both the debt and equity funds used to finance utility plant additions during the construction period. In accordance with the uniform system of accounts prescribed by regulatory authorities, AFUDC is capitalized as a part of the cost of utility plant and the debt

AVISTA CORPORATION

related portion is credited currently as a non-cash item in the Consolidated Statements of Income in the line item capitalized interest. The Company generally is permitted, under established regulatory rate practices, to recover the capitalized AFUDC, and a fair return thereon, through its inclusion in rate base and the provision for depreciation after the related utility plant is placed in service. Cash inflow related to AFUDC generally does not occur until the related utility plant is placed in service and included in rate base.

The effective AFUDC rate was 9.72 percent for 2004, 2003 and the second half of 2002 and 9.03 percent for the first half of 2002. The Company's AFUDC rates do not exceed the maximum allowable rates as determined in accordance with the requirements of regulatory authorities.

Depreciation

For utility operations, depreciation expense is estimated by a method of depreciation accounting utilizing unit rates for generation plants and composite rates for other utility plant. Such rates are designed to provide for retirements of properties at the expiration of their service lives. The rates for hydroelectric plants include annuity and interest components, in which the interest component is 9 percent. For utility operations, the ratio of depreciation provisions to average depreciable property was 2.92 percent in 2004, 2.98 percent in 2003 and 2.92 percent in 2002.

The average service lives for the following broad categories of utility property are: electric thermal production - 30 years; hydroelectric production - 77 years; electric transmission - 43 years; electric distribution - 47 years; and natural gas distribution property - 35 years.

The Company recovers certain asset retirement costs through rates charged to customers as a portion of its depreciation expense. The Company had estimated retirement costs of \$175.6 million and \$167.1 million included as a regulatory liability on the Consolidated Balance Sheets as of December 31, 2004 and 2003, respectively. These costs do not represent legal or contractual obligations.

Goodwill

Goodwill arising from acquisitions represents the excess of the purchase price over the estimated fair value of net assets acquired. The Company evaluates goodwill for impairment using a discounted cash flow model on at least an annual basis or more frequently if impairment indicators arise. Goodwill is included in non-utility properties and investments-net on the Consolidated Balance Sheets and totaled \$6.2 million (\$5.2 million in the Other business segment and \$1.0 million in Energy Marketing and Resource Management) and \$7.5 million (\$6.6 million in the Other business segment and \$0.9 million in Energy Marketing and Resource Management) as of December 31, 2004 and 2003, respectively. The Company completed its annual evaluation of goodwill for potential impairment during the first quarter of 2004 and determined that goodwill was not impaired at that time.

Based on a revised financial forecast, which indicated a decline in the performance and value of a reporting unit in the Other business segment, the Company performed an evaluation of goodwill for that reporting unit in December 2004. The Company determined that \$1.4 million of goodwill was impaired, which is included in administrative and general expense in the Consolidated Statement of Income. The Company used a discounted cash flow model based on a multiple of earnings before interest, taxes, depreciation and amortization to estimate the fair value of this business unit.

On January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill no longer be amortized. Accordingly, the Company determined that \$4.1 million (net of tax) of goodwill was impaired and recorded this as a cumulative effect of accounting change for 2002.

Regulatory Deferred Charges and Credits

The Company prepares its consolidated financial statements in accordance with the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." The Company prepares its financial statements in accordance with SFAS No. 71 because (i) the Company's rates for regulated services are established by or subject to approval by an independent third-party regulator; (ii) the regulated rates are designed to recover the Company's cost of providing the regulated services; and (iii) in view of demand for the regulated services and the level of competition, it is reasonable to assume that rates can be charged to and collected from customers at levels that will recover the Company's costs. SFAS No. 71 requires the Company to reflect the impact of regulatory decisions in its financial statements. SFAS No. 71 requires that certain costs and/or obligations (such as incurred power and natural gas costs not currently recovered through rates, but expected to be recovered in the future) are reflected as deferred charges on the Consolidated Balance Sheets. These costs and/or obligations are not reflected in the statement of income until the period during which matching revenues are recognized. If at some point in the future the Company

AVISTA CORPORATION

determines that it no longer meets the criteria for continued application of SFAS No. 71 with respect to all or a portion of the Company's regulated operations, the Company could be required to write-off its regulatory assets. The Company could also be precluded from the future deferral of costs not recovered through rates at the time such costs are incurred, even if the Company expected to recover such costs in the future.

The Company's primary regulatory assets include power and natural gas deferrals (see "Power Cost Deferrals and Recovery Mechanisms" and "Natural Gas Cost Deferrals and Recovery Mechanisms" below for further information), investment in exchange power, regulatory asset for deferred income taxes, unamortized debt expense, regulatory asset for consolidation of variable interest entity (see Note 2 for further information), demand side management programs, conservation programs and the provision for postretirement benefits. Those items without a specific line on the Consolidated Balance Sheets are included in other regulatory assets. Other regulatory assets consisted of the following as of December 31 (dollars in thousands):

	2004	2003
Regulatory asset for consolidation of variable interest entity	\$19,167	\$16,707
Regulatory asset for postretirement benefit obligation	3,782	4,255
Demand side management and conservation programs	13,792	19,683
Other	<u>2,303</u>	<u>3,736</u>
Total	<u>\$39,044</u>	<u>\$44,381</u>

Regulatory liabilities include utility plant retirement costs. Deferred credits include, among other items, regulatory liabilities created when the Centralia Power Plant was sold, regulatory liabilities offsetting net energy commodity derivative assets (see Note 6 for further information) and the gain on the general office building sale/leaseback, which is being amortized over the life of the lease, and are included on the Consolidated Balance Sheets as other current liabilities and other non-current liabilities and deferred credits.

Regulatory assets that are not currently included in rate base, being recovered in current rates or earning a return (accruing interest), totaled \$22.4 million as of December 31, 2004. The most significant of these assets was the \$19.2 million regulatory asset for the consolidation of a variable interest entity (WP Funding LP). Avista Utilities' lease payments to WP Funding LP of \$4.5 million are being recovered in current rates; the regulatory asset primarily represents the accumulated difference between depreciation expense on the plant and the principal payments made on the debt obligation (see Note 2), which will be reversed in future periods as debt principal payments are made.

Investment in Exchange Power-Net

The investment in exchange power represents the Company's previous investment in Washington Public Power Supply System Project 3 (WNP-3), a nuclear project that was terminated prior to completion. Under a settlement agreement with the Bonneville Power Administration in 1985, Avista Utilities began receiving power in 1987, for a 32.5-year period, related to its investment in WNP-3. Through a settlement agreement with the Washington Utilities and Transportation Commission (WUTC) in the Washington jurisdiction, Avista Utilities is amortizing the recoverable portion of its investment in WNP-3 (recorded as investment in exchange power) over a 32.5 year period beginning in 1987. For the Idaho jurisdiction, Avista Utilities has fully amortized the recoverable portion of its investment in exchange power.

Unamortized Debt Expense

Unamortized debt expense includes debt issuance costs that are amortized over the life of the related debt, as well as premiums paid to repurchase debt, which are amortized over the average remaining maturity of outstanding debt in accordance with regulatory accounting practices under SFAS No. 71. These costs are recovered through retail rates as a component of interest expense.

Natural Gas Benchmark Mechanism

The Idaho Public Utilities Commission (IPUC), WUTC and Oregon Public Utility Commission (OPUC) approved Avista Utilities' Natural Gas Benchmark Mechanism in 1999. The mechanism eliminated the majority of natural gas procurement operations within Avista Utilities and placed responsibility for natural gas procurement operations with Avista Energy, the Company's non-regulated subsidiary. The ownership of the natural gas assets remains with Avista Utilities; however, the assets have been managed by Avista Energy through an Agency Agreement. Avista Utilities has continued to manage natural gas procurement for its California operations, which the Company has entered into an agreement to sell (see Note 27).

AVISTA CORPORATION

In the first quarter of 2002, the IPUC and the OPUC approved the continuation of the Natural Gas Benchmark Mechanism and related Agency Agreement through March 31, 2005. In February 2004, the WUTC ordered that the Natural Gas Benchmark Mechanism and related Agency Agreement be terminated for Washington customers and ordered Avista Utilities to file a transition plan to move management of these functions back into Avista Utilities. In April 2004, the WUTC approved Avista Utilities' transition plan, which provides for the movement of these functions back into Avista Utilities to be completed by March 31, 2005. Effective April 1, 2005, the Company will also be moving these functions from Avista Energy to Avista Utilities for Idaho and Oregon natural gas customers with the expiration of the current agreements.

In accordance with SFAS No. 71, profits recognized by Avista Energy on natural gas sales to Avista Utilities, including gains and losses on natural gas contracts, are not eliminated in the consolidated financial statements. This is due to the fact that Avista Utilities expects to recover the costs of natural gas purchases to serve retail customers and for fuel for electric generation through future retail rates.

Power Cost Deferrals and Recovery Mechanisms

Avista Utilities defers the recognition in the income statement of certain power supply costs as approved by the WUTC. Deferred power supply costs are recorded as a deferred charge on the Consolidated Balance Sheets for future review and the opportunity for recovery through retail rates. The power supply costs deferred include certain differences between actual power supply costs incurred by Avista Utilities and the costs included in base retail rates. This difference in power supply costs primarily results from changes in short-term wholesale market prices, changes in the level of hydroelectric generation and changes in the level of thermal generation (including changes in fuel prices). Avista Utilities accrues interest on deferred power costs in the Washington jurisdiction at a rate, which is adjusted semi-annually, of 8.4 percent as of December 31, 2004. Total deferred power costs for Washington customers were \$113.2 million and \$125.7 million as of December 31, 2004 and 2003, respectively.

In Washington, the Energy Recovery Mechanism (ERM) allows Avista Utilities to increase or decrease electric rates periodically with WUTC approval to reflect changes in power supply costs. The ERM provides for Avista Utilities to incur the cost of, or receive the benefit from, the first \$9.0 million in annual power supply costs above or below the amount included in base retail rates. Under the ERM, 90 percent of annual power supply costs exceeding or below the initial \$9.0 million are deferred for future surcharge or rebate to Avista Utilities' customers. The remaining 10 percent of power supply costs are an expense of, or benefit to, the Company.

Under the ERM, Avista Utilities makes an annual filing to provide the opportunity for the WUTC and other interested parties to review the prudence of and audit the ERM deferred power cost transactions for the prior calendar year. The ERM provides for a 90-day review period for the filing; however, the period may be extended by agreement of the parties or by WUTC order. In August 2004, the WUTC issued an order, which approved the recovery of \$22.8 million of deferred power costs incurred in 2003.

Avista Utilities has a power cost adjustment (PCA) mechanism in Idaho that allows it to modify electric rates periodically with IPUC approval. Under the PCA mechanism, Avista Utilities defers 90 percent of the difference between certain actual net power supply expenses and the authorized level of net power supply expense approved in the last Idaho general rate case. Avista Utilities accrues interest on deferred power costs in the Idaho jurisdiction at a rate, which is adjusted annually, of 1.0 percent on current year deferrals and 3.0 percent on carryover balances as of December 31, 2004. In October 2004, the IPUC issued its final order with respect to general electric and natural gas rate cases filed by Avista Utilities in Idaho. The final order required Avista Utilities to write off a total of \$12.0 million (recorded as resource costs in the Consolidated Statements of Income) of certain deferred power costs, including associated accrued interest, related to natural gas contracts entered into by Avista Utilities to provide fuel for its generating facilities. The IPUC authorized the recovery of the remaining deferred power costs over a two-year period through a PCA rate surcharge to customers. Total deferred power costs for Idaho customers were \$9.5 million and \$30.3 million as of December 31, 2004 and 2003, respectively.

Natural Gas Cost Deferrals and Recovery Mechanisms

Under established regulatory practices in each respective state, Avista Utilities is allowed to adjust its natural gas rates periodically (with regulatory approval) to reflect increases or decreases in the cost of natural gas purchased. Differences between actual natural gas costs and the natural gas costs already included in retail rates are deferred and charged or credited to expense when regulators approve inclusion of the cost changes in rates. Total deferred natural gas costs were \$28.6 million (including \$3.1 million related to California operations, which is classified as an asset held for sale) and \$15.4 million as of December 31, 2004 and 2003, respectively.

Intersegment Eliminations

Intersegment eliminations are reported in operating revenues, resource costs and interest expense in the Schedule of Information by Business Segments. Intersegment eliminations reported as operating revenues and resource costs represent the transactions between Avista Utilities and Avista Energy for energy commodities and services, primarily natural gas purchased by Avista Utilities under the Agency Agreement. Intersegment eliminations reported as interest expense represent intercompany interest.

Reclassifications

Certain prior period amounts were reclassified to conform to current statement format. These reclassifications were made for comparative purposes and to conform to changes in accounting standards and have not affected previously reported total net income or stockholders' equity.

NOTE 2. NEW ACCOUNTING STANDARDS

In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." This statement requires the Company to classify certain financial instruments as liabilities that have historically been classified as equity. This statement requires the Company to classify as a liability financial instruments that are subject to mandatory redemption at a specified or determinable date or upon an event that is certain to occur. This statement was effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective at the beginning of the first interim period beginning after June 15, 2003. The restatement of financial statements for prior periods was not permitted. The adoption of this statement required the Company to classify preferred stock subject to mandatory redemption as a liability on the Consolidated Balance Sheets. The adoption of this statement also required the Company to classify preferred stock dividends subsequent to July 1, 2003 as interest expense in the Consolidated Statements of Income.

In July 2003, the EITF reached consensus on Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not Held for Trading Purposes as Defined in EITF Issue No. 02-3." This EITF Issue requires that revenues and resource costs from Avista Utilities' settled energy contracts that are "booked out" (not physically delivered) should be reported on a net basis as part of operating revenues effective October 1, 2003. Derivatives not held for trading purposes at Avista Energy are reported gross, unless they are "booked out" or the economic substance indicates that net reporting is appropriate. The adoption of this EITF Issue resulted in a reduction in operating revenues and resource costs of approximately \$26.4 million for 2004 as compared to 2003 for Avista Utilities.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities," which was revised in December 2003 (collectively referred to as FIN 46). In general, a variable interest entity does not have equity investors with voting rights or it has equity investors that do not provide sufficient financial resources for the entity to support its activities. Variable interest entities are commonly referred to as special purpose entities or off-balance sheet structures; however, FIN 46 applies to a broader group of entities. FIN 46 requires a variable interest entity to be consolidated by the primary beneficiary of that entity. The primary beneficiary is subject to a majority of the risk of loss from the variable interest entity's activities or it is entitled to receive a majority of the entity's residual returns. FIN 46 also requires disclosure of variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 applied immediately to variable interest entities created after January 31, 2003 and applied to certain existing variable interest entities for the first fiscal year or interim period ending after December 15, 2003. Application for all other types of entities was required for periods ending after March 15, 2004.

FIN 46 required the Company to consolidate WP Funding LP effective for the period ended December 31, 2003 and thereafter. WP Funding LP is an entity that was formed in 1993 for the purpose of acquiring the natural gas-fired combustion turbine generating facility in Rathdrum, Idaho (Rathdrum CT). WP Funding LP purchased the Rathdrum CT from the Company with funds provided by unrelated investors of which 97 percent represented debt and 3 percent represented equity. The Company operates the Rathdrum CT and leases it from WP Funding LP. The total amount of WP Funding LP debt outstanding was \$54.6 million as of December 31, 2004 and 2003. The lease term expires in February 2020; however, the current debt matures in October 2005 and will need to be refinanced at that time. As of December 31, 2004, the book value of the debt and equity of WP Funding LP exceeded the book value of the Rathdrum CT by \$19.2 million. In accordance with regulatory accounting practices, the Company recorded this amount as a regulatory asset upon the consolidation of WP Funding LP. The addition of the Rathdrum CT, which entered commercial operation in 1995, to Avista Utilities' generation resource base was reviewed in

AVISTA CORPORATION

previous state regulatory filings with the WUTC and IPUC.

FIN 46 also resulted in the Company no longer including the capital trusts formed for the purpose of issuing preferred trust securities in its consolidated financial statements for the period ended December 31, 2003 and thereafter. The capital trusts are considered variable interest entities under the provisions of FIN 46. As Avista Corp. is not the primary beneficiary, these entities are no longer included in Avista Corp.'s consolidated financial statements. The sole assets of the capital trusts are \$113.4 million of junior subordinated deferrable interest debentures of Avista Corp. and the deconsolidation of these entities resulted in these debentures being reflected on the Consolidated Balance Sheets. Interest expense to affiliated trusts in the Consolidated Statements of Income represents interest expense on these debentures.

Additionally, the implementation of FIN 46, as revised in December 2003, resulted in the Company including a partnership as well as several low-income housing project investments held in the Other business segment in its consolidated financial statements for 2004. This resulted in a charge of \$0.5 million recorded as a cumulative effect of accounting change for 2004.

See Note 11 for a discussion of a FASB Staff Position with respect to postretirement medical benefit obligations.

In December 2004, the FASB issued SFAS No. 123R, "Accounting for Stock-Based Compensation," which supersedes APB No. 25 and its related implementation guidance. This statement establishes standards for the accounting for transactions in which the Company exchanges its equity instruments for goods or services with a primary focus on transactions in which the Company obtains employee services in share-based payment transactions. The statement requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. The Company will be required to implement the provisions of this statement beginning in the third quarter of 2005. The Company expects to record compensation expense (net of tax) of approximately \$0.5 million in 2005 and \$0.3 million in 2006 related to the periodic vesting of stock options granted to employees in prior years. As the Company is not currently granting stock options to employees, the prospective provisions of this statement are not expected to have a material effect on the Company's future financial condition, results of operations or cash flows.

NOTE 3. DISCONTINUED OPERATIONS

In 2003, private equity investors made investments in a new entity, ReliOn, Inc. (formerly AVL B, Inc.), which acquired the assets previously held by Avista Corp.'s fuel cell manufacturing and development subsidiary, Avista Labs. Avista Corp.'s investment in ReliOn, Inc. is accounted for under the cost method. Revenues for Avista Labs were \$0.7 million and \$0.7 million in 2003 (through June 30) and 2002, respectively.

In September 2001, the Company reached a decision that it would dispose of substantially all of the assets of Avista Communications. The divestiture of the operating assets of Avista Communications was complete by the end of 2002. Revenues for Avista Communications were \$3.5 million in 2002.

Amounts reported as discontinued operations for 2003 represent the operations of Avista Labs. Amounts reported as discontinued operations represent the operations of Avista Labs and Avista Communications as follows for 2002:

	Avista Labs	Avista Communications	Total
Income (loss) before income taxes	\$(12,960)	\$2,499	\$(10,461)
Minority interest	241	-	241
Income tax benefit (expense)	<u>4,855</u>	<u>(1,354)</u>	<u>3,501</u>
Income (loss) from discontinued operations	<u>\$ (7,864)</u>	<u>\$1,145</u>	<u>\$ (6,719)</u>

NOTE 4. IMPAIRMENT OF ASSETS

During the third quarter of 2004, the Company recorded an impairment charge for a turbine and related equipment owned by Avista Power (Energy Marketing and Resource Management segment). This charge of \$5.1 million is included in operations and maintenance expense in the Consolidated Statements of Income. The Company originally planned to use four turbines in a non-regulated generation project. Due to changing market conditions during 2001, the Company decided to no longer pursue the development of this project and reached an agreement to sell three of the turbines. During 2002, 2003 and the first three quarters of 2004, the Company explored various options for use of the fourth turbine. At the end of the third quarter of 2004, the Company reached a conclusion to

AVISTA CORPORATION

sell the turbine and related equipment, which are classified as assets held for sale on the Consolidated Balance Sheet as of December 31, 2004. The Company evaluated the carrying value of the turbine and related equipment and recorded an impairment charge to adjust the book value of these assets to estimated fair value less selling costs.

During the fourth quarter of 2003, the Company recorded an impairment charge for the turbine owned by Avista Power (see discussion above). This charge of \$4.9 million for 2003 is included in operations and maintenance expense in the Consolidated Statements of Income.

NOTE 5. ACCOUNTS RECEIVABLE SALE

Avista Receivables Corp. (ARC) is a wholly owned, bankruptcy-remote subsidiary of the Company formed for the purpose of acquiring or purchasing interests in certain accounts receivable, both billed and unbilled, of the Company. On May 29, 2002, ARC, the Company and a third-party financial institution entered into a three-year agreement whereby ARC can sell without recourse, on a revolving basis, up to \$100.0 million of those receivables. In April 2004, the revolving amount available for sale was reduced to \$85.0 million. ARC is obligated to pay fees that approximate the purchaser's cost of issuing commercial paper equal in value to the interests in receivables sold. On a consolidated basis, the amount of such fees is included in operating expenses of the Company. As of December 31, 2004 and 2003, \$72.0 million in accounts receivables were sold under this revolving agreement.

NOTE 6. UTILITY ENERGY COMMODITY DERIVATIVE ASSETS AND LIABILITIES

SFAS No. 133, as amended by SFAS No. 138 and SFAS No. 149, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires the recording of all derivatives as either assets or liabilities on the balance sheet measured at estimated fair value and the recognition of the unrealized gains and losses. In certain defined conditions, a derivative may be specifically designated as a hedge for a particular exposure. The accounting for derivatives depends on the intended use of the derivatives and the resulting designation.

Avista Utilities enters into forward contracts to purchase or sell energy. Under these forward contracts, Avista Utilities commits to purchase or sell a specified amount of energy at a specified time, or during a specified period, in the future. Certain of these forward contracts are considered derivative instruments. Avista Utilities also records derivative commodity assets and liabilities for over-the-counter and exchange-traded derivative instruments as well as certain long-term contracts. These contracts are entered into as part of Avista Utilities' management of its loads and resources as discussed in Note 7. In conjunction with the issuance of SFAS No. 133, the WUTC and the IPUC issued accounting orders authorizing Avista Utilities to offset any derivative assets or liabilities with a regulatory asset or liability. This accounting treatment is intended to defer the recognition of mark-to-market gains and losses on energy commodity transactions until the period of settlement. The order provides for Avista Utilities to not recognize the unrealized gain or loss on utility derivative commodity instruments in the Consolidated Statements of Income. Realized gains or losses are recognized in the period of settlement, subject to approval for recovery through retail rates. Realized gains and losses, subject to regulatory approval, result in adjustments to retail rates through purchased gas cost adjustments, the ERM and the PCA mechanism.

Prior to the adoption of SFAS No. 149 on July 1, 2003, Avista Utilities elected the normal purchases and sales exception for substantially all of its contracts for both capacity and energy under SFAS No. 133. As such, Avista Utilities was not required to record these contracts as derivative commodity assets and liabilities. Under SFAS No. 149, substantially all new forward contracts to purchase or sell power and natural gas used for generation, which were entered into on or after July 1, 2003, are recorded as assets or liabilities at market value with an offsetting regulatory asset or liability. Contracts that are not considered derivatives under SFAS No. 133 are generally accounted for at cost until they are settled or realized, unless there is a decline in the fair value of the contract that is determined to be other than temporary. Utility energy commodity derivatives consisted of the following as of December 31 (dollars in thousands):

	2004	2003
Current utility energy commodity derivative asset	\$10,199	\$4,983
Current utility energy commodity derivative liability	5,713	2,997
Net current regulatory liability	4,486	1,986
Non-current utility energy commodity derivative asset	55,825	34,517
Non-current utility energy commodity derivative liability	33,490	33,060
Net non-current regulatory liability	22,335	1,457

AVISTA CORPORATION

Current utility energy commodity derivative assets are included in other current assets on the Consolidated Balance Sheets. Current utility energy commodity derivative liabilities and the offsetting net current regulatory liability are included in other current liabilities on the Consolidated Balance Sheets. The offsetting net non-current regulatory liability is included in other non-current liabilities and deferred credits on the Consolidated Balance Sheets.

NOTE 7. ENERGY COMMODITY TRADING

The Company's energy-related businesses are exposed to risks relating to, but not limited to, changes in certain commodity prices, interest rates, foreign currency and counterparty performance. In order to manage the various risks relating to these exposures, Avista Utilities utilizes derivative instruments, such as forwards, futures, swaps and options, and Avista Energy engages in the trading of such instruments. Avista Utilities and Avista Energy use a variety of techniques to manage risks for their energy resources and wholesale energy market activities. The Company has risk management policies and procedures to manage these risks, both qualitative and quantitative, for Avista Utilities and Avista Energy. The Company's Risk Management Committee establishes the Company's risk management policies and procedures and monitors compliance. The Risk Management Committee is comprised of certain Company officers and other individuals and is overseen by the Audit Committee of the Company's Board of Directors.

Avista Utilities

Avista Utilities engages in an ongoing process of resource optimization, which involves the pursuit of economic resources to serve load obligations and using existing resources to capture available economic value. Avista Utilities sells and purchases wholesale electric capacity and energy to and from utilities and other entities as part of the process of acquiring resources to serve its retail and wholesale load obligations. These transactions range from a term as short as one hour up to long-term contracts that extend beyond one year. Avista Utilities makes continuing projections of (1) future retail and wholesale loads based on, among other things, forward estimates of factors such as customer usage and weather as well as historical data and contract terms and (2) resource availability based on, among other things, estimates of streamflows, generating unit availability, historic and forward market information and experience. On the basis of these continuing projections, Avista Utilities makes purchases and sales of energy on an annual, quarterly, monthly, daily and hourly basis to match expected resources to expected energy requirements. Resource optimization also includes transactions such as purchasing fuel to run thermal generation and, when economic, selling fuel and substituting electric wholesale market purchases for the operation of Avista Utilities' own resources, as well as other wholesale transactions to capture the value of available generation and transmission resources. This optimization process includes entering into financial and physical hedging transactions as a means of managing risks.

Avista Utilities manages the impact of fluctuations in electric energy prices by measuring and controlling the volume of energy imbalance between projected loads and resources and through the use of derivative commodity instruments for hedging purposes. Load/resource imbalances within a rolling 18-month planning horizon are compared against established volumetric guidelines and management determines the timing and specific actions to manage the imbalances. Management also assesses available resource decisions and actions that are appropriate for longer-term planning periods. Avista Energy is responsible for the daily management of natural gas supplies to meet the requirements of Avista Utilities' customers in the states of Washington, Idaho and Oregon. In February 2004, the WUTC ordered that these functions be moved back to Avista Utilities for Washington customers, and in April 2004, the WUTC approved Avista Utilities' transition plan to move these functions back into Avista Utilities by March 31, 2005. Effective April 1, 2005, the Company will also be moving these functions back to Avista Utilities for Idaho and Oregon customers with the expiration of current agreements. As part of the transition plan, Avista Utilities has begun procuring natural gas for load service. This procurement process includes entering into financial and physical hedging transactions as a means of managing risks. See description of Natural Gas Benchmark Mechanism in Note 1 for further information. Avista Utilities has continued to manage natural gas procurement for its California operations, which the Company has entered into an agreement to sell (see Note 27 for further information).

Avista Energy

Avista Energy is an electricity and natural gas marketing, trading and resource management business. Avista Energy focuses on optimization of combustion turbines and hydroelectric assets owned by other entities, long-term electric supply contracts, natural gas storage, and electric transmission and natural gas transportation arrangements. Avista Energy is also involved in trading electricity and natural gas, including derivative commodity instruments. Avista Energy purchases natural gas and electricity from producers and energy marketing and trading companies. Its customers include commercial and industrial end-users, electric utilities, natural gas distribution companies, and energy marketing and trading companies.

Avista Energy's marketing and energy risk management services are provided through the use of a variety of derivative commodity contracts to purchase or supply natural gas and electric energy at specified delivery points and at specified future dates. Avista Energy trades natural gas and electricity derivative commodity instruments on national exchanges and through other exchanges and brokers, and therefore can experience net open positions in terms of price, volume, and specified delivery point. The open positions expose Avista Energy to the risk that fluctuating market prices may adversely impact its financial condition or results of operations. However, the net open positions are actively managed with policies designed to limit the exposure to market risk and requiring daily reporting to management of potential financial exposure.

Avista Energy measures the risk in its electric and natural gas portfolio daily utilizing a Value-at-Risk (VAR) model, which monitors its risk in comparison to established thresholds. VAR measures the expected portfolio loss under hypothetical adverse price movements over a given time interval within a given confidence level. Avista Energy also measures its open positions in terms of volumes at each delivery location for each forward time period. The permissible extent of open positions is included in the risk management policy and is measured with stress tests and VAR modeling.

Derivative commodity instruments sold and purchased by Avista Energy include: forward contracts, which involve physical delivery of an energy commodity; futures contracts, which involve the buying or selling of natural gas or electricity at a fixed price; over-the-counter swap agreements, which require Avista Energy to receive or make payments based on the difference between a specified price and the actual price of the underlying commodity; and options, which mitigate price risk by providing for the right, but not the requirement, to buy or sell energy-related commodities at a fixed price. Foreign currency risks are primarily related to Canadian exchange rates and are managed using standard instruments available in the foreign currency markets.

Avista Energy's derivative commodity instruments accounted for under SFAS No. 133 are subject to mark-to-market accounting, under which changes in the market value of outstanding electric, natural gas and related derivative commodity instruments are recognized as unrealized gains or losses in the Consolidated Statements of Income in the period of change. Market prices are utilized in determining the value of electric, natural gas and related derivative commodity instruments, which are reported as assets and liabilities on the Consolidated Balance Sheets. These market prices are used through 36 months. Prior to the fourth quarter of 2004, market prices for electric commodity prices were used through 24 months. Increased market liquidity has resulted in the availability of reliable and transparent market prices for a longer time period than had been previously available. For longer-term positions and certain short-term positions for which market prices are not available, a model to estimate forward price curves is utilized. Avista Energy reports the net margin on derivative commodity instruments held for trading as operating revenues. Revenues from contracts, which are not derivatives under SFAS No. 133 and derivative commodity instruments not held for trading, are reported on a gross basis in operating revenues. Costs from contracts, which are not derivatives under SFAS No. 133 and derivative instruments not held for trading, are reported on a gross basis in resource costs. Contracts in a receivable position, as well as the options held, are reported as assets. Similarly, contracts in a payable position, as well as options written, are reported as liabilities. Net cash flows are recognized in the period of settlement.

Avista Energy implemented hedge accounting in accordance with SFAS No. 133 during the third quarter of 2003. Specific natural gas and electric trading derivative contracts have been designated as hedging instruments in cash flow hedging relationships. The hedge strategies represent cash flow hedges of the variable price risk associated with expected purchases of natural gas and sales of electricity. These designated hedging instruments represent hedges of variable price exposures generated from certain contracts, which do not qualify as derivatives under SFAS No. 133. For all derivatives designated as cash flow hedges, Avista Energy documents the relationship between the hedging instrument and the hedged item (forecasted purchases and sales of power and natural gas), as well as the risk management objective and strategy for using the hedging instrument. Avista Energy assesses whether a change in the value of the designated derivative is highly effective in achieving offsetting cash flows attributable to the hedged item, both at the inception of the hedge and on an ongoing basis. Any changes in the fair value of the designated derivative that are effective are recorded in accumulated other comprehensive income or loss, while changes in fair value that are not effective are recognized currently in earnings as operating revenues. Amounts recorded in accumulated other comprehensive income or loss are recognized in earnings during the period that the hedged items are recognized in earnings.

During 2004, a gain of \$1.0 million related to hedge ineffectiveness was recorded in earnings as operating revenues. Of this \$1.0 million, \$0.7 million is related to portions of hedging relationships that have settled during 2004. As of

AVISTA CORPORATION

December 31, 2004, there was a net gain of \$0.1 million (net of tax) in accumulated other comprehensive income (loss) related to designated cash flow hedges, while a gain of \$0.5 million (net of tax) was reclassified from accumulated comprehensive income (loss) and recognized in earnings during 2004. During 2003, a gain of less than \$0.1 million related to hedge ineffectiveness was recorded in earnings as operating revenues. As of December 31, 2003, there was a gain of \$1.8 million (net of tax) in accumulated other comprehensive income (loss) related to designated cash flow hedges, while a gain of \$0.5 million (net of tax) was reclassified from accumulated comprehensive income (loss) and recognized in earnings during 2003. Of the amount in accumulated other comprehensive income (loss) as of December 31, 2004, there was a gain of \$1.6 million (net of tax) related to natural gas derivatives and a loss of \$1.5 million (net of tax) related to electricity derivatives. Avista Energy expects to recognize a gain of \$0.1 million in earnings during the next 12 months, related to amounts currently in accumulated other comprehensive income (loss). The actual amounts that will be recognized in earnings during the next 12 months will vary from the expected amounts as a result of changes in market prices. The maximum term of the designated hedging instruments was 12 months.

Contract Amounts and Terms Under Avista Energy's derivative instruments, Avista Energy either (i) as "fixed price payor," is obligated to pay a fixed price or a fixed amount and is entitled to receive the commodity or a fixed amount, (ii) as "fixed price receiver," is entitled to receive a fixed price or a fixed amount and is obligated to deliver the commodity or pay a fixed amount, (iii) as "index price payor," is obligated to pay an indexed price or an indexed amount and is entitled to receive the commodity or a variable amount or (iv) as "index price receiver," is entitled to receive an indexed price or amount and is obligated to deliver the commodity or pay a variable amount. The contract or notional amounts and terms of Avista Energy's derivative commodity instruments outstanding as of December 31, 2004 are set forth below (in thousands of mmbtUs and MWhs):

	Fixed Price Payor	Fixed Price Receiver	Maximum Terms in Years	Index Price Payor	Index Price Receiver	Maximum Terms in Years
Energy commodities (volumes)						
Electric	32,562	34,105	13	1,382	1,500	2
Natural gas	259,003	257,752	5	1,814,707	1,796,044	3

The weighted average term of Avista Energy's electric derivative commodity instruments as of December 31, 2004 was approximately 7 months. The weighted average term of Avista Energy's natural gas derivative commodity instruments as of December 31, 2004 was approximately 4 months.

Estimated Fair Value The estimated fair value of Avista Energy's derivative commodity instruments outstanding as of December 31, 2004, and the average estimated fair value of those instruments held during the year ended December 31, 2004, are set forth below (dollars in thousands):

	Estimated Fair Value as of December 31, 2004				Average Estimated Fair Value for the year ended December 31, 2004			
	Current Assets	Long-term Assets	Current Liabilities	Long-term Liabilities	Current Assets	Long-term Assets	Current Liabilities	Long-term Liabilities
Electric	\$156,580	\$234,225	\$134,810	\$197,030	\$178,794	\$229,522	\$159,780	\$191,275
Natural gas	<u>127,651</u>	<u>20,432</u>	<u>118,717</u>	<u>18,025</u>	<u>120,747</u>	<u>21,125</u>	<u>115,166</u>	<u>13,917</u>
Total	<u>\$284,231</u>	<u>\$254,657</u>	<u>\$253,527</u>	<u>\$215,055</u>	<u>\$299,541</u>	<u>\$250,647</u>	<u>\$274,946</u>	<u>\$205,192</u>

The change in the estimated fair value position of Avista Energy's energy commodity portfolio, net of reserves for credit and market risk for 2004 was an unrealized loss of \$0.7 million and is included in the Consolidated Statements of Income in operating revenues. The change in the fair value position for 2003 was an unrealized loss of \$22.1 million. In 2002, the unrealized loss was \$91.9 million.

Market Risk

Market risk is, in general, the risk of fluctuation in the market price of the commodity being traded and is influenced primarily by supply and demand. Market risk includes the fluctuation in the market price of associated derivative commodity instruments. Market risk is influenced to the extent that the performance or nonperformance by market participants of their contractual obligations and commitments affect the supply of, or demand for, the commodity. Avista Utilities and Avista Energy manage the market risks inherent in their activities according to risk policies established by the Company's Risk Management Committee.

Credit Risk

Credit risk relates to the risk of loss that Avista Utilities and/or Avista Energy would incur as a result of non-performance by counterparties of their contractual obligations to deliver energy or make financial settlements. Avista Utilities and Avista Energy often extend credit to counterparties and customers. Credit risk includes the risk that a counterparty may default due to circumstances relating directly to it and the risk that a counterparty may default due to circumstances that relate to other market participants that have a direct or indirect relationship with such counterparty. Should a counterparty, customer or supplier fail to perform, Avista Utilities or Avista Energy may be required to replace existing contracts with contracts at then-current market prices or to honor the underlying commitment. Avista Utilities and Avista Energy seek to mitigate credit risk by applying specific eligibility criteria to existing and prospective counterparties and by actively monitoring current credit exposures. These policies include an evaluation of the financial condition and credit ratings of counterparties, collateral requirements or other credit enhancements, such as letters of credit or parent company guarantees, and the use of standardized agreements that allow for the netting or offsetting of positive and negative exposures associated with a single counterparty.

Avista Energy has concentrations of suppliers and customers in the electric and natural gas industries including electric utilities, natural gas distribution companies, and other energy marketing and trading companies. In addition, Avista Energy has concentrations of credit risk related to geographic location as Avista Energy operates in the western United States and western Canada. These concentrations of counterparties and concentrations of geographic location may impact Avista Energy's overall exposure to credit risk, either positively or negatively, because the counterparties may be similarly affected by changes in economic, regulatory or other conditions.

Credit risk also involves the exposure that counterparties perceive related to the ability of Avista Utilities and Avista Energy to perform deliveries and settlement under physical and financial energy contracts. These counterparties may seek assurances of performance in the form of letters of credit, prepayment or cash deposits and, in the case of Avista Energy, parent company (Avista Capital) performance guarantees. In periods of price volatility, the level of exposure can change significantly, with the result that sudden and significant demands may be made against the Company's capital resource reserves (credit facilities and cash). Avista Utilities and Avista Energy actively monitor the exposure to possible collateral calls and take steps to minimize capital requirements.

Other Operating Risks

In addition to commodity price risk, Avista Utilities' commodity positions are subject to operational and event risks including, among others, increases in load demand, transmission or transport disruptions, fuel quality specifications, changes in regulatory requirements, forced outages at generating plants and disruptions to information systems and other administrative tools required for normal operations. Avista Utilities also has exposure to weather conditions and natural disasters that can cause physical damage to property, requiring repairs to restore utility service. The emergence of terrorism threats, both domestic and foreign, is a risk to the entire utility industry, including Avista Utilities. Potential disruptions to operations or destruction of facilities from terrorism or other malicious acts are not readily determinable. The Company has taken various steps to mitigate terrorism risks and to prepare contingency plans in the event that its facilities are targeted.

NOTE 8. CASH DEPOSITS WITH AND FROM COUNTERPARTIES

Cash deposits from counterparties totaled \$6.0 million and \$97.8 million as of December 31, 2004 and 2003, respectively. These funds are held by Avista Utilities and Avista Energy to mitigate the potential impact of counterparty default risk. These amounts are subject to return if conditions warrant because of continuing portfolio value fluctuations with those parties or substitution of non-cash collateral. Cash deposited with counterparties totaled \$30.7 million and \$36.8 million as of December 31, 2004 and 2003, respectively, and is included in other current assets on the Consolidated Balance Sheets.

As is common industry practice, Avista Utilities and Avista Energy maintain margin agreements with certain counterparties. Margin calls are triggered when exposures exceed predetermined contractual limits or when there are changes in a counterparty's creditworthiness. Price movements in electricity and natural gas can generate exposure levels in excess of these contractual limits. From time to time, margin calls are made and/or received by Avista Utilities and Avista Energy. Negotiating for collateral in the form of cash, letters of credit, or parent company performance guarantees is a common industry practice.

NOTE 9. JOINTLY OWNED ELECTRIC FACILITIES

As of December 31, 2004, the Company had a 50 percent ownership interest in a combined cycle natural gas-fired turbine power plant, the Coyote Springs 2 Generation Plant (Coyote Springs 2) located in north-central Oregon, which was placed into operation in 2003. The Company's share of related fuel costs as well as operating and maintenance expenses for plant in service are included in the corresponding accounts in the Consolidated Statements of Income. The Company's share of utility plant in service for Coyote Springs 2 was \$108.8 million and accumulated depreciation was \$6.7 million as of December 31, 2004. In January 2005, the Company acquired the remaining 50 percent ownership interest in Coyote Springs 2 at a price of \$62.5 million. See Note 28 for further information.

The Company has a 15 percent ownership interest in a twin-unit coal-fired generating facility, the Colstrip Generating Project (Colstrip) located in southeastern Montana, and provides financing for its ownership interest in the project. The Company's share of related fuel costs as well as operating and maintenance expenses for plant in service are included in the corresponding accounts in the Consolidated Statements of Income. The Company's share of utility plant in service for Colstrip was \$320.2 million and accumulated depreciation was \$172.4 million as of December 31, 2004.

NOTE 10. PROPERTY, PLANT AND EQUIPMENT

The balances of the major classifications of property, plant and equipment are detailed in the following table as of December 31 (dollars in thousands):

	2004	2003
Avista Utilities:		
Electric production	\$ 924,933	\$ 914,021
Electric transmission	337,651	304,827
Electric distribution	760,400	724,054
Construction work-in-progress (CWIP) and other	109,222	119,552
Electric total	<u>2,132,206</u>	<u>2,062,454</u>
Natural gas underground storage	18,566	18,543
Natural gas distribution	449,155	449,501
CWIP and other	44,691	45,340
Natural gas total	<u>512,412</u>	<u>513,384</u>
Common plant (including CWIP)	73,087	79,789
Total Avista Utilities	2,717,705	2,655,627
Energy Marketing and Resource Management (1)	15,790	30,162
Avista Advantage (1)	13,688	12,847
Other (1)	34,757	23,886
Total	<u>\$2,781,940</u>	<u>\$2,722,522</u>

(1) Included in non-utility properties and investments-net on the Consolidated Balance Sheets.

Equipment under capital leases at Avista Utilities totaled \$5.3 million and \$3.9 million as of December 31, 2004 and 2003, respectively. The associated accumulated depreciation totaled \$0.5 million and \$0.2 million as of December 31, 2004 and 2003, respectively. Property, plant, and equipment under capital leases at Avista Capital's subsidiaries totaled \$5.3 million and \$5.3 million as of December 31, 2004 and 2003, respectively. The associated accumulated depreciation totaled \$3.5 million and \$2.9 million as of December 31, 2004 and 2003, respectively.

NOTE 11. PENSION PLANS AND OTHER POSTRETIREMENT BENEFIT PLANS

The Company has a defined benefit pension plan covering substantially all of its regular full-time employees at Avista Utilities and Avista Energy. Individual benefits under this plan are based upon the employee's years of service and average compensation as specified in the plan. The Company's funding policy is to contribute at least the minimum amounts that are required to be funded under the Employee Retirement Income Security Act, but not more than the maximum amounts that are currently deductible for income tax purposes. The Company made \$15 million in cash contributions to the pension plan in 2004 and \$12 million in each of 2003 and 2002. The Company expects to contribute approximately \$15 million to the pension plan in 2005.

AVISTA CORPORATION

The Finance Committee of the Company's Board of Directors establishes investment policies, objectives and strategies to seek optimum return for the pension plan, while also keeping with the assumption of prudent risk and the Finance Committee's composite return objectives. The Finance Committee reviews and approves changes to the investment policy. The Company has contracted with an investment manager who is responsible for managing the individual investment managers. The investment manager's performance and related individual fund performance is periodically reviewed by the Finance Committee to ensure compliance with investment policy objectives and strategies. Pension plan assets are invested primarily in marketable debt and equity securities. Pension plan assets may also be invested in real estate and other investments, including hedge funds and venture capital funds. In seeking to obtain the desired return to fund the pension plan, the Finance Committee has established investment allocation percentages by asset classes as indicated in the table below.

The assumed long-term rate of return on plan assets is based on past performance and economic forecasts for the types of investments held by the plan. The fair value of pension plan assets invested in debt and equity securities was based primarily on market prices. The fair value of pension plan assets invested in real estate was determined based on three basic approaches: (1) current cost of reproducing a property less deterioration and functional economic obsolescence (2) capitalization of the property's net earnings power; and (3) value indicated by recent sales of comparable properties in the market. The fair value of plan assets was determined as of December 31, 2004 and 2003.

As of December 31, 2004 and 2003, the pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. In 2004, the pension plan funding deficit increased as compared to the end of 2003 and as such the Company increased the additional minimum liability for the unfunded accumulated benefit obligation by \$9.2 million and reduced the intangible asset by \$0.7 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in a charge to other comprehensive income of \$6.4 million, net of taxes of \$3.5 million for 2004. In 2003, the pension plan funding deficit decreased as compared to the end of 2002 and as such the Company reduced the additional minimum liability for the unfunded accumulated benefit obligation by \$15.5 million and the intangible asset by \$0.6 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in an increase to other comprehensive income of \$9.7 million, net of taxes of \$5.2 million for 2003. In 2002, the Company recorded an additional minimum liability for the unfunded accumulated benefit obligation of \$33.4 million and an intangible asset of \$6.4 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in a charge to other comprehensive income of \$17.6 million, net of taxes of \$9.4 million for 2002.

The Company also has a Supplemental Executive Retirement Plan (SERP) that provides additional pension benefits to executive officers of the Company. The SERP is intended to provide benefits to executive officers whose benefits under the pension plan are reduced due to the application of Section 415 of the Internal Revenue Code of 1986 and the deferral of salary under deferred compensation plans. The Company recorded an additional minimum liability for the unfunded accumulated benefit obligation of \$1.8 million, \$0.3 million and \$0.7 million related to the SERP for 2004, 2003 and 2002, respectively. This resulted in a charge to other comprehensive income of \$1.2 million, \$0.2 million and \$0.5 million, net of tax, for 2004, 2003 and 2002, respectively.

The Company expects that benefit payments under the pension plan and the SERP will total \$14.1 million, \$14.0 million, \$15.2 million, \$15.5 million and \$16.2 million in 2005, 2006, 2007, 2008 and 2009, respectively. For the ensuing five years (2010 through 2014), the Company expects that benefit payments under the pension plan and the SERP will total \$102.4 million.

The Company provides certain health care and life insurance benefits for substantially all of its retired employees. The Company accrues the estimated cost of postretirement benefit obligations during the years that employees provide services. The Company elected to amortize the transition obligation of \$34.5 million over a period of twenty years, beginning in 1993. In 2004, the Company recognized the effect of an amendment to the cost-sharing policy, which limits the employer portion of the premium for all retirees. This amendment reduced the accumulated benefit obligation by \$4.3 million. The Company expects that benefit payments under the postretirement benefit plan will be \$3.1 million, \$3.1 million, \$3.1 million, \$3.0 million and \$3.0 million in 2005, 2006, 2007, 2008 and 2009, respectively. For the ensuing five years (2010 through 2014), the Company expects that benefit payments under the postretirement benefit plan will total \$14.5 million.

The Company uses a December 31 measurement date for its pension and postretirement plans.

AVISTA CORPORATION

The following table sets forth the pension and postretirement plan disclosures as of December 31, 2004 and 2003 and the components of net periodic benefit costs for the years ended December 31, 2004, 2003 and 2002 (dollars in thousands):

	Pension Benefits		Post-retirement Benefits	
	2004	2003	2004	2003
Change in benefit obligation:				
Benefit obligation as of beginning of year.....	\$265,790	\$238,385	\$39,185	\$29,062
Service cost	8,914	7,806	480	482
Interest cost	16,406	15,705	2,019	2,477
Plan amendment	-	-	(4,263)	-
Actuarial loss (gain)	8,737	18,046	(2,464)	10,973
Benefits paid.....	(13,309)	(13,226)	(3,042)	(3,741)
Expenses paid.....	(800)	(926)	(47)	(68)
Benefit obligation as of end of year.....	<u>\$285,738</u>	<u>\$265,790</u>	<u>\$31,868</u>	<u>\$39,185</u>
Change in plan assets:				
Fair value of plan assets as of beginning of year	\$167,962	\$136,125	\$14,587	\$11,301
Actual return on plan assets.....	16,816	33,129	1,882	3,282
Employer contributions	15,000	12,000	1,964	1,785
Benefits paid.....	(12,399)	(12,366)	(1,524)	(1,713)
Expenses paid.....	(800)	(926)	(47)	(68)
Fair value of plan assets as of end of year	<u>\$186,579</u>	<u>\$167,962</u>	<u>\$16,862</u>	<u>\$14,587</u>
Funded status.....	<u>\$(99,159)</u>	<u>\$(97,828)</u>	<u>\$(15,006)</u>	<u>\$(24,598)</u>
Unrecognized net actuarial loss.....	73,604	71,695	6,009	9,455
Unrecognized prior service cost.....	5,058	5,712	-	-
Unrecognized net transition obligation/(asset)	(499)	(1,585)	4,041	8,809
Accrued benefit cost.....	(20,996)	(22,006)	(4,956)	(6,334)
Additional minimum liability	(31,112)	(20,081)	-	-
Accrued benefit liability	<u>\$(52,108)</u>	<u>\$(42,087)</u>	<u>\$(4,956)</u>	<u>\$(6,334)</u>
Accumulated pension benefit obligation	<u>\$238,687</u>	<u>\$210,049</u>	-	-
Accumulated postretirement benefit obligation:				
For retirees			\$18,914	\$26,073
For fully eligible employees.....			\$5,672	\$5,427
For other participants			\$7,282	\$7,685
Weighted-average asset allocations as of December 31				
Equity securities	63%	64%	64%	59%
Debt securities	26%	25%	36%	41%
Real estate	5%	5%	-	-
Other.....	6%	6%	-	-
Target asset allocations as of December 31				
Equity securities	54-68%	54-68%	52-72%	-
Debt securities	22-28%	22-28%	28-48%	-
Real estate	3-7%	3-7%	-	-
Other.....	5-13%	5-13%	-	-
Weighted Average Assumptions as of December 31				
Discount rate for benefit obligation.....	5.75%	6.25%	5.75%	6.25%
Discount rate for annual expense.....	6.25%	6.75%	6.25%	6.75%
Expected long-term return on plan assets.....	8.00%	8.00%	8.00%	8.00%
Rate of compensation increase (1)	4.84%	5.00%	-	-
Medical cost trend pre-age 65 – initial.....			9.00%	8.00%
Medical cost trend pre-age 65 – ultimate			5.00%	5.00%
Ultimate medical cost trend year pre-age 65			2009	2007
Medical cost trend post-age 65 – initial			9.00%	9.00%
Medical cost trend post-age 65 – ultimate.....			6.00%	6.00%
Ultimate medical cost trend year post-age 65.....			2008	2007

(1) In 2004, changed to an age-based scale ranging from 2.50 percent to 8.00 percent.

AVISTA CORPORATION

	2004	2003	2002	2004	2003	2002
Components of net periodic benefit cost:						
Service cost	\$ 8,914	\$ 7,806	\$ 6,734	\$ 480	\$ 482	\$ 304
Interest cost	16,406	15,705	15,119	2,019	2,477	2,184
Expected return on plan assets	(13,436)	(10,862)	(12,311)	(1,106)	(842)	(1,064)
Transition (asset)/obligation recognition...	(1,086)	(1,086)	(1,086)	505	979	1,256
Amortization of prior service cost	654	653	831	-	-	-
Net loss recognition	<u>3,447</u>	<u>3,896</u>	<u>1,021</u>	<u>245</u>	<u>405</u>	-
Net periodic benefit cost	<u>\$14,899</u>	<u>\$16,112</u>	<u>\$10,308</u>	<u>\$2,143</u>	<u>\$3,501</u>	<u>\$2,680</u>

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point increase in the assumed health care cost trend rate for each year would increase the accumulated postretirement benefit obligation as of December 31, 2004 by \$2.3 million and the service and interest cost by \$0.2 million. A one-percentage-point decrease in the assumed health care cost trend rate for each year would decrease the accumulated postretirement benefit obligation as of December 31, 2004 by \$2.0 million and the service and interest cost by \$0.2 million.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (2003 Medicare Act) was signed into law. The 2003 Medicare Act expanded Medicare to include, for the first time, coverage for prescription drugs. In May 2004, the FASB issued Staff Position No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." The Company implemented the 2003 Medicare Act and the related FASB Staff Position in 2004, which reduced the accumulated benefit obligation by \$2.7 million as of December 31, 2004 and the 2004 postretirement benefit expense by less than \$0.1 million.

The Company has a salary deferral 401(k) plan (Employee Investment Plan) that is a defined contribution plan and covers substantially all employees. Employees can make contributions to their respective accounts in the Employee Investment Plan on a pre-tax basis up to the maximum amount permitted by law. The Company matches a portion of the salary deferred by each participant according to the schedule in the Employee Investment Plan. Employer matching contributions of \$4.1 million, \$3.8 million and \$3.6 million were expensed in 2004, 2003 and 2002, respectively.

The Company has an Executive Deferral Plan. This plan allows executive officers and other key employees the opportunity to defer until the earlier of their retirement, termination, disability or death, up to 75 percent of their base salary and/or up to 100 percent of their incentive cash payments. Deferred compensation funds are held by the Company in a Rabbi Trust. As of December 31, 2004 and 2003, there were deferred compensation assets of \$11.5 million included in other property and investments-net and corresponding deferred compensation liabilities of \$11.5 million included in other non-current liabilities and deferred credits on the Consolidated Balance Sheets.

NOTE 12. ACCOUNTING FOR INCOME TAXES

As of December 31, 2004 and 2003, the Company had net regulatory assets of \$123.2 million and \$131.8 million, respectively, related to the probable recovery of certain deferred tax liabilities from customers through future rates.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and tax credit carryforwards. The total net deferred income tax liability consisted of the following as of December 31 (dollars in thousands):

	2004	2003
Deferred income tax assets:		
Allowance for doubtful accounts	\$ 16,428	\$ 16,201
Reserves not currently deductible	19,450	16,167
Alternative minimum tax	16,877	7,502
Contributions in aid of construction	6,840	8,677
Deferred compensation	5,138	4,904
Unfunded accumulated benefit obligation	8,732	4,645
Other	<u>12,316</u>	<u>8,041</u>
Total deferred income tax assets	<u>\$ 85,781</u>	<u>\$ 66,137</u>

AVISTA CORPORATION

	2004	2003
Deferred income tax liabilities:		
Differences between book and tax basis of utility plant.....	\$424,907	\$404,017
Power and natural gas deferrals	53,259	58,912
Unrealized energy commodity gains	24,542	27,290
Power exchange contract	39,436	41,725
Demand side management programs.....	3,866	4,459
Loss on reacquired debt	11,315	8,405
Other	<u>4,639</u>	<u>2,673</u>
Total deferred income tax liabilities.....	<u>561,964</u>	<u>547,481</u>
Net deferred income tax liability.....	<u>\$476,183</u>	<u>\$481,344</u>

Net current deferred income tax assets were \$12.3 million and \$11.5 million as of December 31, 2004 and 2003, respectively. Net non-current deferred tax liabilities were \$488.5 million and \$492.8 million as of December 31, 2004 and 2003, respectively.

The realization of deferred tax assets is dependent upon the ability to generate taxable income in future periods. The Company evaluated available evidence supporting the realization of its deferred tax assets and determined it is more likely than not that deferred tax assets will be realized.

A reconciliation of federal income taxes derived from statutory federal tax rates (35 percent in 2004, 2003 and 2002) applied to pre-tax income from continuing operations as set forth in the accompanying Consolidated Statements of Income is as follows for the years ended December 31 (dollars in thousands):

	2004	2003	2002
Federal income taxes at statutory rates.....	\$20,022	\$30,094	\$26,958
Increase (decrease) in tax resulting from:			
Tax effect of regulatory treatment of			
utility plant differences	2,268	4,046	5,166
State income tax expense	696	1,283	2,348
Preferred dividends	759	383	-
Settlement of prior year tax returns and			
adjustment of tax reserves.....	(2,449)	457	525
Other-net.....	<u>296</u>	<u>(923)</u>	<u>(148)</u>
Total income tax expense.....	<u>\$21,592</u>	<u>\$35,340</u>	<u>\$34,849</u>
Income Tax Expense Consisted of the Following:			
Taxes currently provided.....	\$ 2,424	\$ 6,945	\$75,136
Deferred income taxes.....	<u>19,168</u>	<u>28,395</u>	<u>(40,287)</u>
Total income tax expense.....	<u>\$21,592</u>	<u>\$35,340</u>	<u>\$34,849</u>

NOTE 13. ENERGY PURCHASE CONTRACTS

Avista Utilities has contracts related to the purchase of fuel for thermal generation, natural gas and hydroelectric power. The termination dates of the contracts range from one month to the year 2044. Avista Utilities also has various agreements for the purchase, sale or exchange of electric energy with other utilities, cogenerators, small power producers and government agencies. Total expenses for power purchased, natural gas purchased, fuel for generation and other fuel costs, which are included in resource costs in the Consolidated Statements of Income, were \$482.2 million, \$464.1 million and \$382.4 million in 2004, 2003 and 2002, respectively.

The following table details Avista Utilities' future contractual commitments for power resources (including transmission contracts) and natural gas resources (including transportation contracts) (dollars in thousands):

	2005	2006	2007	2008	2009	Thereafter	Total
Power resources	\$142,656	\$92,507	\$95,523	\$95,981	\$96,542	\$353,128	\$876,337
Natural gas resources ..	<u>127,108</u>	<u>50,073</u>	<u>55,457</u>	<u>45,173</u>	<u>39,808</u>	<u>396,403</u>	<u>714,022</u>
Total	<u>\$269,764</u>	<u>\$142,580</u>	<u>\$150,980</u>	<u>\$141,154</u>	<u>\$136,350</u>	<u>\$749,531</u>	<u>\$1,590,359</u>

AVISTA CORPORATION

All of the energy purchase contracts were entered into as part of Avista Utilities' obligation to serve its retail natural gas and electric customers' energy requirements. As a result, these costs are generally recovered either through base retail rates or adjustments to retail rates as part of the power and natural gas cost deferral and recovery mechanisms.

In addition, Avista Utilities has operational agreements, settlements and other contractual obligations with respect to its generation, transmission and distribution facilities. The expenses associated with these agreements are reflected as operations and maintenance expenses in the Consolidated Statements of Income. The following table details future contractual commitments with respect to these agreements (dollars in thousands):

	2005	2006	2007	2008	2009	Thereafter	Total
Contractual obligations.....	<u>\$14,516</u>	<u>\$14,516</u>	<u>\$14,516</u>	<u>\$14,516</u>	<u>\$14,516</u>	<u>\$176,789</u>	<u>\$249,369</u>

Avista Utilities has fixed contracts with certain Public Utility Districts (PUD) to purchase portions of the output of certain generating facilities. Although Avista Utilities has no investment in the PUD generating facilities, the fixed contracts obligate Avista Utilities to pay certain minimum amounts (based in part on the debt service requirements of the PUD) whether or not the facility is operating. The cost of power obtained under the contracts, including payments made when a facility is not operating, is included in resource costs in the Consolidated Statements of Income. Expenses under these PUD contracts were \$7.3 million, \$8.5 million and \$7.8 million in 2004, 2003 and 2002, respectively. Information as of December 31, 2004, pertaining to these PUD contracts is summarized in the following table (dollars in thousands):

	Company's Current Share of					Expiration Date
	Output	Kilowatt Capability	Annual Costs (1)	Debt Service Costs (1)	Bonds Outstanding	
Chelan County PUD:						
Rocky Reach Project.....	2.9%	37,000	\$1,848	\$990	\$ 2,952	2011
Douglas County PUD:						
Wells Project.....	3.5	30,000	1,079	528	5,015	2018
Grant County PUD:						
Priest Rapids Project.....	6.1	55,000	1,868	795	10,961	2040
Wanapum Project.....	8.2	<u>75,000</u>	<u>2,522</u>	<u>1,056</u>	<u>14,888</u>	2040
Totals		<u>197,000</u>	<u>\$7,317</u>	<u>\$3,369</u>	<u>\$33,816</u>	

- (1) The annual costs will change in proportion to the percentage of output allocated to Avista Utilities in a particular year. Amounts represent the operating costs for the year 2004. Debt service costs are included in annual costs.

The estimated aggregate amounts of required minimum payments (Avista Utilities' share of existing debt service costs) under these PUD contracts are as follows (dollars in thousands):

	2005	2006	2007	2008	2009	Thereafter	Total
Minimum payments.....	<u>\$3,636</u>	<u>\$2,957</u>	<u>\$3,255</u>	<u>\$3,115</u>	<u>\$3,230</u>	<u>\$20,472</u>	<u>\$36,665</u>

In addition, Avista Utilities will be required to pay its proportionate share of the variable operating expenses of these projects.

Avista Energy's contractual commitments to purchase energy commodities as well as commitments related to transmission, transportation and other energy-related contracts in future periods are as follows (dollars in thousands):

	2005	2006	2007	2008	2009	Thereafter	Total
Energy contracts.....	<u>\$649,913</u>	<u>\$282,635</u>	<u>\$178,802</u>	<u>\$190,875</u>	<u>\$180,106</u>	<u>\$522,515</u>	<u>\$2,004,846</u>

Avista Energy also has sales commitments related to these contractual obligations in future periods.

AVISTA CORPORATION
NOTE 14. LONG-TERM DEBT

The following details the interest rate and maturity dates of long-term debt outstanding as of December 31 (dollars in thousands):

Maturity Year	Description	Interest Rate	2004	2003
2005	Secured Medium-Term Notes.....	6.39%-6.68%	\$ 29,500	\$ 29,500
2005	WP Funding LP Note.....	8.38%	54,572	54,572
2006	Secured Medium-Term Notes.....	7.89%-7.90%	30,000	30,000
2007	First Mortgage Bonds.....	7.75%	150,000	150,000
2007	Secured Medium-Term Notes (1).....	5.99%	13,850	-
2008	Secured Medium-Term Notes (1).....	6.06%-6.95%	45,000	20,000
2010	Secured Medium-Term Notes (1).....	6.67%-8.02%	35,000	10,000
2012	Secured Medium-Term Notes.....	7.37%	7,000	7,000
2013	First Mortgage Bonds.....	6.13%	45,000	45,000
2018	Secured Medium-Term Notes.....	7.26%-7.45%	27,500	27,500
2019	First Mortgage Bonds (2).....	5.45%	90,000	-
2023	Secured Medium-Term Notes.....	7.18%-7.54%	24,500	24,500
2028	Secured Medium-Term Notes (1).....	6.37%	25,000	-
2032	Pollution Control Bonds (1).....	5.00%	66,700	-
2034	Pollution Control Bonds (1).....	5.13%	17,000	-
	Total secured long-term debt.....		<u>660,622</u>	<u>398,072</u>
2004	Unsecured Medium-Term Notes.....	7.42%	-	28,500
2006	Unsecured Medium-Term Notes.....	8.14%	8,000	8,000
2007	Unsecured Medium-Term Notes (1).....	5.99%-7.94%	12,000	25,850
2008	Unsecured Senior Notes.....	9.75%	280,827	317,683
2008	Unsecured Medium-Term Notes (1).....	6.06%	-	25,000
2010	Unsecured Medium-Term Notes (1).....	8.02%	-	25,000
2022	Unsecured Medium-Term Notes.....	8.15%	5,000	5,000
2023	Unsecured Medium-Term Notes.....	7.99%	5,000	5,000
2023	Pollution Control Bonds.....	6.00%	4,100	4,100
2028	Unsecured Medium-Term Notes (1).....	6.37%	-	25,000
2032	Pollution Control Bonds (1).....	5.00%	-	66,700
2034	Pollution Control Bonds (1).....	5.13%	-	17,000
	Total unsecured long-term debt.....		<u>314,927</u>	<u>552,833</u>
	Other long-term debt and capital leases.....		<u>13,047</u>	<u>5,812</u>
	Unamortized debt discount.....		<u>(1,608)</u>	<u>(1,994)</u>
	Total.....		986,988	954,723
	Current portion of long-term debt.....		<u>(85,432)</u>	<u>(29,711)</u>
	Total long-term debt.....		<u>\$901,556</u>	<u>\$925,012</u>

- (1) In December 2004, the Company issued \$172.6 million of non-transferable First Mortgage Bonds (Collateral Bonds) under its Mortgage and Deed of Trust, dated as of June 1, 1939, as amended and supplemented (Mortgage), in order to provide the benefit of the lien of the Mortgage to secure its obligations with respect to previously issued and outstanding unsecured debt securities, including \$88.9 million of its Medium Term Notes, Series C and the municipal bond insurance policies insuring \$83.7 million of Pollution Control Revenue Bonds issued for the benefit of the Company by the City of Forsyth, Montana. The Collateral Bonds were issued in order to suspend certain negative covenants, which had limited the Company's ability to issue additional secured debt.
- (2) In November 2004, the Company issued \$90.0 million of 5.45 percent First Mortgage Bonds due in 2019. The Company used the proceeds to repay a portion of the borrowings outstanding under its committed line of credit.

The following table details future long-term debt maturities, including long-term debt to affiliated trusts (see Note 15) (dollars in thousands):

Year	2005	2006	2007	2008	2009	Thereafter	Total
Debt maturities.....	\$84,072	\$38,000	\$175,850	\$325,827	\$ -	\$465,203	\$1,088,952

In September 1999, \$83.7 million of Pollution Control Revenue Refunding Bonds (Avista Corporation Colstrip Project), Series 1999A due 2032 and Series 1999B due 2034 were issued by the City of Forsyth, Montana. The proceeds of the bonds were utilized to refund the \$66.7 million of 7.13 percent First Mortgage Bonds due 2013 and the \$17.0 million of 7.40 percent First Mortgage Bonds due 2016. The Series 1999A and Series 1999B Bonds are backed by an insurance policy issued by AMBAC Assurance Corporation. In January 2002, the interest rate on the bonds was fixed for a period of seven years at a rate of 5.00 percent for Series 1999A and 5.13 percent for Series 1999B. As described above, in December 2004, the Company secured these obligations through the issuance of First Mortgage Bonds.

During 2004, the Company repurchased \$36.6 million of 9.75 percent Senior Notes scheduled to mature in 2008. In accordance with regulatory accounting practices, the total net premium on the repurchase of debt of \$6.7 million will be amortized over the average remaining maturity of outstanding debt.

In January and February 2005, the Company repurchased the following debt securities: \$5.0 million of Secured Medium-Term Notes scheduled to mature in 2018; \$11.0 million of Secured Medium-Term Notes scheduled to mature in 2023; \$5.0 million Unsecured Medium-Term Notes scheduled to mature in 2022; and \$5.0 million of Unsecured Medium-Term Notes scheduled to mature in 2023.

In April 2004, the Company filed an amended registration statement on Form S-3 with the Securities and Exchange Commission, which would allow for the issuance of up to \$349.6 million of securities (either debt or common stock). This filing amended and combined three previous registration statements filed by the Company. As of December 31, 2004, the Company had remaining availability of \$259.6 million under this registration statement.

Substantially all utility properties owned by the Company are subject to the lien of the Company's various mortgage indentures. The Mortgage and Deed of Trust securing the Company's First Mortgage Bonds (including Secured Medium-Term Notes) contains limitations on the amount of First Mortgage Bonds, which may be issued based on, among other things, a 70 percent debt-to-collateral ratio, and/or retired First Mortgage Bonds, and a 2 to 1 net earnings to First Mortgage Bond interest ratio. As of December 31, 2004, the Company could issue \$400.0 million of additional First Mortgage Bonds under the Mortgage and Deed of Trust. See Note 16 for information regarding First Mortgage Bonds issued to secure the Company's obligations under a \$350.0 million committed line of credit.

NOTE 15. LONG-TERM DEBT TO AFFILIATED TRUSTS

In April 2004, the Company issued Junior Subordinated Debt Securities, with a principal amount of \$61.9 million to AVA Capital Trust III, an affiliated business trust formed by the Company. Concurrently, AVA Capital Trust III issued \$60.0 million of Preferred Trust Securities to third parties and \$1.9 million of Common Trust Securities to the Company. All of these securities have a fixed interest rate of 6.50 percent for five years (through March 31, 2009). Subsequent to the initial five-year fixed rate period, the securities will either have a new fixed rate or an adjustable rate. These debt securities may be redeemed by the Company on or after March 31, 2009 and will mature on April 1, 2034.

The Company used the proceeds from the Junior Subordinated Debt Securities to redeem \$61.9 million of 7.875 percent Junior Subordinated Deferrable Interest Debentures, Series A, originally issued in 1997 to Avista Capital I, an affiliated business trust formed by the Company. Avista Capital I used these proceeds to redeem \$60.0 million of Preferred Trust Securities issued to third parties and \$1.9 million of Common Trust Securities issued to the Company.

In 1997, the Company issued Floating Rate Junior Subordinated Deferrable Interest Debentures, Series B, with a principal amount of \$51.5 million to Avista Capital II, an affiliated business trust formed by the Company. Avista Capital II issued \$50.0 million of Preferred Trust Securities with a floating distribution rate of LIBOR plus 0.875 percent, calculated and reset quarterly. The annual distribution rate paid during 2004 ranged from 1.995 percent to 3.275 percent. As of December 31, 2004, the annual distribution rate was 3.275 percent. Concurrent with the issuance of the Preferred Trust Securities, Avista Capital II issued \$1.5 million of Common Trust Securities to the Company. These debt securities may be redeemed at the option of Avista Capital II on or after June 1, 2007 and mature on June 1, 2037; however, this is limited by an agreement under the Company's 9.75 percent Senior Notes that mature in 2008. In December 2000, the Company purchased \$10.0 million of these Preferred Trust Securities.

The Company has guaranteed the payment of distributions on, and redemption price and liquidation amount with respect to, the Preferred Trust Securities to the extent that AVA Capital Trust III and Avista Capital II have funds

AVISTA CORPORATION

available for such payments from the respective debt securities. Upon maturity or prior redemption of such debt securities, the Preferred Trust Securities will be mandatorily redeemed. As discussed in Note 2, FIN 46 results in the Company no longer including these capital trusts in its consolidated financial statements as of December 31, 2003 and thereafter.

NOTE 16. SHORT-TERM BORROWINGS

On December 17, 2004, the Company entered into a five-year committed line of credit with various banks in the amount of \$350.0 million with an expiration date of December 16, 2009. This committed line of credit replaced a \$350.0 million committed line of credit with a 364-day term that had an expiration date of May 5, 2005. The Company can request the issuance of up to \$150.0 million in letters of credit under the committed line of credit. As of December 31, 2004 and 2003, there were \$32.8 million and \$10.7 million in letters of credit outstanding, respectively. The committed line of credit is secured by \$350.0 million of non-transferable First Mortgage Bonds of the Company issued to the agent bank. Such First Mortgage Bonds would only become due and payable in the event, and then only to the extent, that the Company defaults on its obligations under the committed line of credit.

The committed line of credit agreement contains customary covenants and default provisions, including covenants not to permit the ratio of "consolidated total debt" to "consolidated total capitalization" of Avista Corp. to be greater than 70 percent at the end of any fiscal quarter. As of December 31, 2004, the Company was in compliance with this covenant with a ratio of 59.9 percent. The committed line of credit also has a covenant requiring the ratio of "earnings before interest, taxes, depreciation and amortization" to "interest expense" of Avista Utilities for the twelve-month period ending December 31, 2004 to be greater than 1.6 to 1. As of December 31, 2004, the Company was in compliance with this covenant with a ratio of 2.27 to 1.

Balances and interest rates of bank borrowings under the Company's revolving committed lines of credit were as follows as of and for the years ended December 31 (dollars in thousands):

	2004	2003	2002
Balance outstanding at end of period	\$68,000	\$80,000	\$30,000
Maximum balance outstanding during the period	170,000	85,000	90,000
Average balance outstanding during the period	54,858	26,034	47,027
Average interest rate during the period	3.14%	2.99%	3.59%
Average interest rate at end of period.....	3.52	3.70	3.39

On July 23, 2004, Avista Energy and its subsidiary, Avista Energy Canada, as co-borrowers, amended its committed credit agreement with a group of banks in the aggregate amount of \$110.0 million to extend the expiration date to July 22, 2005. This committed credit facility provides for the issuance of letters of credit to secure contractual obligations to counterparties. This facility is guaranteed by Avista Capital and secured by the assets of Avista Energy and Avista Energy Canada. The maximum amount of credit extended by the banks for the issuance of letters of credit is the subscribed amount of the facility less the amount of outstanding cash advances, if any. The maximum amount of credit extended by the banks for cash advances is \$30.0 million. No cash advances were outstanding as of December 31, 2004 and 2003. Letters of credit in the aggregate amount of \$91.3 million and \$15.0 million were outstanding as of December 31, 2004 and 2003, respectively. The cash deposits of Avista Energy at the respective banks collateralized \$21.5 million and \$15.0 million of these letters of credit as of December 31, 2004 and 2003, respectively, which is reflected as restricted cash on the Consolidated Balance Sheets

The Avista Energy credit agreement contains customary covenants and default provisions, including covenants to maintain "minimum net working capital" and "minimum net worth," as well as a covenant limiting the amount of indebtedness that the co-borrowers may incur. The credit agreement also contains covenants and other restrictions related to Avista Energy's trading limits and positions, including VAR limits, restrictions with respect to changes in risk management policies or volumetric limits, and limits on exposure related to hourly and daily trading of electricity. Also, a reduction in the credit rating of Avista Corp. would represent an event of default under Avista Energy's credit agreement. These covenants, certain counterparty agreements and current market liquidity conditions result in Avista Energy maintaining certain levels of cash and therefore effectively limit the amount of cash dividends that are available for distribution to Avista Capital and ultimately to Avista Corp. Avista Energy was in compliance with the covenants of its credit agreement as of December 31, 2004.

NOTE 17. INTEREST RATE SWAP AGREEMENTS

In July, August and December 2004, Avista Corp. entered into three forward-starting interest rate swap agreements, totaling \$200.0 million, to manage the risk that changes in interest rates may affect the amount of future interest payments. These interest rate swap agreements relate to the anticipated issuances of debt to fund debt that matures in 2007 and 2008. Under the terms of these agreements, the value of the interest rate swaps are determined based upon Avista Corp. paying a fixed rate and receiving a variable rate based on LIBOR for a term of seven years beginning in 2007 and a term of ten years beginning in 2008. The interest rate swap agreements provide for mandatory cash settlement of these contracts in 2008 and 2009. These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. As of December 31, 2004, Avista Corp. had a derivative liability of \$6.5 million. An unrealized loss of \$4.2 million (net of taxes of \$2.3 million) was recorded in other comprehensive loss for 2004, which is reflected as component of accumulated other comprehensive loss on the Consolidated Balance Sheets. The Company may request regulatory accounting orders to defer the impact of unrealized gains and losses. If such accounting orders were obtained, the Company would record a regulatory asset or liability, which would eliminate the effect of any unrealized gains and losses on these interest rate swap agreements in the Consolidated Statements of Comprehensive Income. If regulatory accounting orders are not obtained prior to the mandatory cash settlements in 2008 and 2009, the amount included in accumulated other comprehensive income or loss at the cash settlement date will be reclassified to unamortized debt expense in accordance with regulatory accounting practices under SFAS No. 71. This gain or loss will be amortized over the remaining life of the forecasted debt issued.

Rathdrum Power, LLC (RP LLC), an unconsolidated entity that is 49 percent owned by Avista Power, operates a 270 MW natural gas-fired combustion turbine plant in northern Idaho (Lancaster Project). Avista Power's investment in RP LLC, which is included in non-utility properties and investments-net on the Consolidated Balance Sheets is accounted for under the equity method and totaled \$19.0 million and \$18.0 million as of December 31, 2004 and 2003, respectively. As of December 31, 2004, RP LLC had \$115.2 million of debt outstanding that is not included in the consolidated financial statements of the Company. There is no recourse to the Company with respect to this debt. RP LLC has entered into two interest rate swap agreements, maturing in 2006, to manage the risk that changes in interest rates may affect the amount of future interest payments. RP LLC agreed to pay fixed rates of interest with the differential paid or received under the interest rate swap agreements recognized as an adjustment to interest expense. These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. The fair value of the interest rate swap agreements was determined by reference to market values obtained from various third party sources. As of December 31, 2004, there was an unrealized loss of \$0.6 million recorded as accumulated other comprehensive loss on the Consolidated Balance Sheets.

NOTE 18. LEASES

The Company has multiple lease arrangements involving various assets, with minimum terms ranging from one to forty-five years. The Company's most significant leased asset is the corporate office building. Certain lease arrangements require the Company, upon the occurrence of specified events, to purchase the leased assets. The Company's management believes the likelihood of the occurrence of the specified events under which the Company could be required to purchase the leased assets is remote. Rental expense under operating leases for 2004, 2003 and 2002 was \$9.9 million, \$14.2 million and \$21.7 million, respectively.

Future minimum lease payments required under operating leases having initial or remaining noncancelable lease terms in excess of one year as of December 31, 2004 were as follows (dollars in thousands):

Year ending December 31:	2005	2006	2007	2008	2009	Thereafter	Total
Minimum payments required.....	\$5,824	\$5,446	\$5,019	\$5,091	\$4,941	\$7,283	\$33,604

The payments under the Avista Corp. capital leases are \$1.1 million in each of 2005 and 2006, \$1.0 million in each of 2007 and 2008, and \$0.1 million in 2009. The payments under the Avista Capital subsidiaries' capital leases are \$0.5 million in each of 2005, 2006 and 2007 and \$0.4 million in 2008.

NOTE 19. GUARANTEES

The \$110.0 million committed credit agreement of Avista Energy and its subsidiary, Avista Energy Canada, as co-borrowers, is guaranteed by Avista Capital and secured by the assets of Avista Energy and Avista Energy Canada. This credit agreement expires on July 22, 2005. This agreement also provides for the issuance of letters of credit to secure contractual obligations to counterparties. No cash advances were outstanding as of December 31, 2004 and 2003. Letters of credit in the aggregate amount of \$91.3 million and \$15.0 million were outstanding as of December 31, 2004 and 2003, respectively.

The Company has guaranteed the payment of distributions on, and redemption price and liquidation amount with respect to, the Preferred Trust Securities issued by its affiliates, AVA Capital Trust III and Avista Capital II, to the extent that these entities have funds available for such payments from the respective debt securities.

In the course of the energy trading business, Avista Capital provides guarantees to other parties with whom Avista Energy may be doing business. At any point in time, Avista Capital is only liable for the outstanding portion of the guarantee, which was \$24.5 million and \$35.0 million as of December 31, 2004 and 2003, respectively. The face value of all performance guarantees issued by Avista Capital for energy trading contracts at Avista Energy was \$391.7 million and \$411.7 million as of December 31, 2004 and 2003, respectively. Most guarantees do not have set expiration dates; however, either party may terminate the guarantee at any time with minimal written notice.

Avista Power, through its equity investment in RP LLC, is a 49 percent owner of the Lancaster Project, which commenced commercial operation in September 2001. Commencing with commercial operations, all of the output from the Lancaster Project is contracted to Avista Energy through 2026 under a power purchase agreement. Avista Corp. has guaranteed the power purchase agreement with respect to the performance of Avista Energy.

NOTE 20. PREFERRED STOCK-CUMULATIVE (SUBJECT TO MANDATORY REDEMPTION)

In September 2004, the Company made a mandatory redemption of 17,500 shares of preferred stock for \$1.75 million. In March 2003, the Company repurchased 17,500 shares of preferred stock for \$1.6 million, satisfying its redemption requirement for 2003. In September 2002, the Company made a mandatory redemption of 17,500 shares of preferred stock for \$1.75 million. On September 15, 2005 and 2006, the Company must redeem 17,500 shares at \$100 per share plus accumulated dividends through a mandatory sinking fund. As such, redemption requirements are \$1.75 million in each of the years 2005 and 2006. The remaining shares must be redeemed on September 15, 2007. The Company has the right to redeem an additional 17,500 shares on each September 15 redemption date; however, this right is limited by an agreement under the Company's 9.75 percent Senior Notes that mature in 2008. Upon involuntary liquidation, all preferred stock will be entitled to \$100 per share plus accrued dividends.

As discussed in Note 2, the Company adopted SFAS No. 150 effective July 1, 2003. The adoption of this statement requires the Company to classify preferred stock subject to mandatory redemption as liabilities and preferred stock dividends as interest expense. The restatement of prior periods was not permitted.

NOTE 21. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying values of cash and cash equivalents, restricted cash, accounts and notes receivable, accounts payable and short-term borrowings are reasonable estimates of their fair values. Energy commodity assets and liabilities as well as securities held for trading are reported at estimated fair value on the Consolidated Balance Sheets.

The fair value of the Company's long-term debt (including current-portion, but excluding capital leases) as of December 31, 2004 and 2003 was estimated to be \$1,054.7 million, or 108 percent of the carrying value of \$975.5 million, and \$1,067.3 million, or 112 percent of the carrying value of \$950.9 million, respectively. The fair value of the Company's mandatorily redeemable preferred stock as of December 31, 2004 and 2003 was estimated to be \$32.0 million, or 107 percent of the carrying value of \$29.8 million, and \$29.9 million, or 95 percent of the carrying value of \$31.5 million, respectively. The fair value of the Company's long-term debt to affiliated trusts as of December 31, 2004 and 2003 was estimated to be \$108.3 million, or 98 percent of the carrying value of \$110.0 million, and \$99.5 million, or 90 percent of the carrying value of \$110.0 million, respectively. The carrying value as of December 31, 2004 and 2003 does not include \$3.4 million of debt that is considered common equity by the affiliated trusts. These estimates were primarily based on available market information.

NOTE 22. COMMON STOCK

In April 1990, the Company sold 1,000,000 shares of its common stock to the Trustee of the Investment and Employee Stock Ownership Plan for Employees of the Company (Plan) for the benefit of the participants and beneficiaries of the Plan. In payment for the shares of common stock, the Trustee issued a promissory note payable to the Company in the amount of \$14.1 million. Dividends paid on the stock held by the Trustee, plus Company contributions to the Plan, if any, are used by the Trustee to make interest and principal payments on the promissory note. The balance of the promissory note receivable from the Trustee (\$0.5 million as of December 31, 2004) is reflected as a reduction to common equity. The shares of common stock are allocated to the accounts of participants in the Plan as the note is repaid. During 2004, 2003 and 2002, the cost recorded for the Plan was \$6.2 million, \$6.9 million and \$6.0 million, respectively. Interest on the note payable to the Company, cash and stock contributions to the Plan and dividends on the shares held by the Trustee was \$0.2 million, \$1.7 million and less than \$0.1 million, respectively during 2004. Interest on the note payable to the Company, cash and stock contributions to the Plan and dividends on the shares held by the Trustee was \$0.3 million, \$1.7 million and \$0.1 million, respectively during 2003. Interest on the note payable to the Company, cash and stock contributions to the Plan and dividends on the shares held by the Trustee was \$0.5 million, \$1.6 million and \$0.1 million, respectively during 2002.

In November 1999, the Company adopted a shareholder rights plan pursuant to which holders of common stock outstanding on February 15, 1999, or issued thereafter, were granted one preferred share purchase right (Right) on each outstanding share of common stock. Each Right, initially evidenced by and traded with the shares of common stock, entitles the registered holder to purchase one one-hundredth of a share of preferred stock of the Company, without par value, at a purchase price of \$70, subject to certain adjustments, regulatory approval and other specified conditions. The Rights will be exercisable only if a person or group acquires 10 percent or more of the outstanding shares of common stock or commences a tender or exchange offer, the consummation of which would result in the beneficial ownership by a person or group of 10 percent or more of the outstanding shares of common stock. Upon any such acquisition, each Right will entitle its holder to purchase, at the purchase price, that number of shares of common stock or preferred stock of the Company (or, in the case of a merger of the Company into another person or group, common stock of the acquiring person or group) that has a market value at that time equal to twice the purchase price. In no event will the Rights be exercisable by a person that has acquired 10 percent or more of the Company's common stock. The Rights may be redeemed, at a redemption price of \$0.01 per Right, by the Board of Directors of the Company at any time until any person or group has acquired 10 percent or more of the common stock. The Rights expire on March 31, 2009. This plan replaced a similar shareholder rights plan that expired in February 2000.

The Company has a Dividend Reinvestment and Stock Purchase Plan under which the Company's shareholders may automatically reinvest their dividends and make optional cash payments for the purchase of the Company's common stock at current market value.

From March 2000 through May 2003, the Company issued shares of its common stock to the Employee Investment Plan rather than having the Plan purchase shares of common stock on the open market. In the fourth quarter of 2000, the Company also began issuing new shares of common stock for the Dividend Reinvestment and Stock Purchase Plan. Shares issued under these plans in 2004, 2003 and 2002 are disclosed in the Consolidated Statements of Stockholders' Equity.

The payment of dividends on common stock is restricted by provisions of certain covenants applicable to preferred stock and long-term debt contained in the Company's Articles of Incorporation and various mortgage indentures. Covenants under the Company's 9.75 percent Senior Notes that mature in 2008 limit the Company's ability to increase its common stock cash dividend to no more than 5 percent over the previous quarter.

AVISTA CORPORATION**NOTE 23. EARNINGS PER COMMON SHARE**

The following table presents the computation of basic and diluted earnings per common share for the years ended December 31 (in thousands, except per share amounts):

	2004	2003	2002
Numerator:			
Income from continuing operations.....	\$35,614	\$50,643	\$42,174
Loss from discontinued operations.....	-	(4,949)	(6,719)
Net income before cumulative effect of accounting change ...	35,614	45,694	35,455
Cumulative effect of accounting change.....	(460)	(1,190)	(4,148)
Net income	35,154	44,504	31,307
Deduct: Preferred stock dividend requirements	-	1,125	2,402
Income available for common stock.....	<u>\$35,154</u>	<u>\$43,379</u>	<u>\$28,905</u>
Denominator:			
Weighted-average number of common shares			
outstanding-basic.....	48,400	48,232	47,823
Effect of dilutive securities:			
Restricted stock	-	-	2
Contingent stock.....	209	244	-
Stock options.....	<u>277</u>	<u>154</u>	<u>49</u>
Weighted-average number of common shares			
outstanding-diluted.....	<u>48,886</u>	<u>48,630</u>	<u>47,874</u>
Earnings per common share, basic:			
Earnings per common share from continuing operations....	\$0.74	\$1.03	\$0.83
Loss per common share from discontinued operations	-	(0.10)	(0.14)
Earnings per common share before cumulative effect			
of accounting change.....	0.74	0.93	0.69
Loss per common share from cumulative effect			
of accounting change.....	(0.01)	(0.03)	(0.09)
Total earnings per common share, basic	<u>\$0.73</u>	<u>\$0.90</u>	<u>\$0.60</u>
Earnings per common share, diluted:			
Earnings per common share from continuing operations....	\$0.73	\$1.02	\$0.83
Loss per common share from discontinued operations	-	(0.10)	(0.14)
Earnings per common share before cumulative effect			
of accounting change.....	0.73	0.92	0.69
Loss per common share from cumulative effect			
of accounting change.....	(0.01)	(0.03)	(0.09)
Total earnings per common share, diluted	<u>\$0.72</u>	<u>\$0.89</u>	<u>\$0.60</u>

Total stock options outstanding that were not included in the calculation of diluted earnings per common share were 730,100, 1,306,200 and 1,445,890 for 2004, 2003 and 2002, respectively. These stock options were excluded from the calculation because they were antidilutive based on the fact that the exercise price of the stock options was higher than the average market price of Avista Corp. common stock during the respective period.

NOTE 24. STOCK COMPENSATION PLANS**Avista Corp.**

In 1998, the Company adopted and shareholders approved an incentive compensation plan, the Long-Term Incentive Plan (1998 Plan). Under the 1998 Plan, certain key employees, directors and officers of the Company and its subsidiaries may be granted stock options, stock appreciation rights, stock awards (including restricted stock) and other stock-based awards and dividend equivalent rights. The Company has available a maximum of 2.5 million shares of its common stock for grant under the 1998 Plan. Beginning in 2000, non-employee directors began receiving options under this plan. The Company is requesting shareholder approval of an additional 1.0 million shares under the 1998 Plan at the May 2005 Annual Meeting of Shareholders.

In 2000, the Company adopted a Non-Officer Employee Long-Term Incentive Plan (2000 Plan), which was not required to be approved by shareholders. The provisions of the 2000 Plan are essentially the same as those under

AVISTA CORPORATION

the 1998 Plan, except for the exclusion of directors and executive officers of the Company. The Company has available a maximum of 2.5 million shares of its common stock for grant under the 2000 Plan.

The Board of Directors has determined that it is no longer in the Company's best interest to issue stock options under the 1998 Plan and the 2000 Plan. Other forms of compensation are in place including the issuance of performance shares to certain officers and other key employees.

The Company has accounted for stock based compensation using APB No. 25, which requires the recognition of compensation expense on the excess, if any, of the market price of the stock at the date of grant over the exercise price of the option. As the exercise price for options granted under the 1998 Plan and the 2000 Plan was equal to the market price at the date of grant, there was no compensation expense recorded by the Company. Currently, SFAS No. 123 requires the disclosure of pro forma net income and earnings per common share had the Company adopted the fair value method of accounting for stock options. Under this statement, the fair value of stock-based awards is calculated with option pricing models. These models require the use of subjective assumptions, including stock price volatility, dividend yield, risk-free interest rate and expected time to exercise. The fair value of options is estimated on the date of grant using the Black-Scholes option-pricing model. See Note 1 for disclosure of pro forma net income and earnings per common share. In December 2004, the FASB issued SFAS No. 123R, which supersedes APB No. 25 and its related implementation guidance. The statement requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued effective beginning in the third quarter of 2005. See Note 2 for further information.

In 2004, the Company granted 152,700 performance shares, all of which are still outstanding as of December 31, 2004, to certain officers and other key employees under the 1998 Plan and the 2000 Plan. In 2003, the Company granted 162,600 performance shares (153,914 outstanding as of December 31, 2004) to certain officers and other key employees under the 1998 Plan and the 2000 Plan. The performance shares will be payable at the Company's option in either cash or common stock three years from the date of grant. The amount of cash paid or common stock issued will range from 0 to 150 percent of the performance shares granted depending on the change in the value of the Company's common stock relative to an external benchmark.

Shares of common stock issued from the exercise of stock options under the 1998 Plan and the 2000 Plan are acquired on the open market. As of December 31, 2004, there were 1.9 million shares available for future stock grants under the 1998 Plan and the 2000 Plan.

The following summarizes stock options activity under the 1998 Plan and the 2000 Plan for the years ended December 31:

	2004	2003	2002
Number of shares under stock options:			
Options outstanding at beginning of year	2,481,886	2,684,350	2,440,475
Options granted	-	24,000	569,800
Options exercised	(99,138)	(37,439)	-
Options canceled	(50,550)	(189,025)	(325,925)
Options outstanding at end of year	<u>2,332,198</u>	<u>2,481,886</u>	<u>2,684,350</u>
Options exercisable at end of year	<u>1,896,648</u>	<u>1,614,455</u>	<u>1,192,775</u>
Weighted average exercise price:			
Options granted	\$ -	\$12.41	\$10.51
Options exercised	\$13.79	\$11.43	-
Options canceled	\$18.46	\$17.78	\$19.88
Options outstanding at end of year	\$15.58	\$15.57	\$15.69
Options exercisable at end of year	\$16.62	\$17.18	\$18.28
Weighted average fair value of options granted during the year	\$ -	\$ 4.30	\$ 3.43
Principal assumptions used in applying the Black-Scholes model:			
Risk-free interest rate	-	3.17%	3.25%-4.96%
Expected life, in years	-	7	7
Expected volatility	-	37.10%	47.13%
Expected dividend yield	-	3.87%	4.61%

AVISTA CORPORATION

Information with respect to options outstanding and options exercisable as of December 31, 2004 was as follows:

Range of Exercise Prices	Number of Shares	Options Outstanding		Options Exercisable	
		Weighted Average Exercise Price	Weighted Average Remaining Life (in years)	Number of Shares	Weighted Average Exercise Price
\$10.17-\$11.68	494,623	\$10.26	7.2	238,073	\$10.26
\$11.69-\$14.61	616,875	11.82	6.2	450,625	11.82
\$14.62-\$17.53	490,600	17.15	4.2	478,100	17.15
\$17.54-\$20.45	271,100	18.73	3.2	270,850	18.73
\$20.46-\$23.38	432,800	22.56	5.0	432,800	22.56
\$26.30-\$28.47	<u>26,200</u>	27.39	5.1	<u>26,200</u>	27.39
Total	<u>2,332,198</u>	\$15.58	5.2	<u>1,896,648</u>	\$16.62

Avista Capital Companies

Certain subsidiaries of Avista Capital have employee stock incentive plans under which certain employees and directors of the subsidiaries are granted options to purchase subsidiary shares at prices no less than the fair market value on the date of grant. Options outstanding under these plans usually vest over periods of between three and five years from the date granted and terminate ten years from the date granted. Employee stock incentive plans related to the Avista Capital subsidiaries are not significant to the consolidated financial statements.

Non-Employee Director Stock Plan

In 1996, the Company adopted and shareholders approved the Non-Employee Director Stock Plan (1996 Director Plan). Under the 1996 Director Plan, directors who are not employees of the Company receive two-thirds of their annual retainer in Avista Corp. common stock. The common stock is acquired on the open market. The Company has available a maximum of 150,000 shares of its common stock under the 1996 Director Plan and there were 65,553 shares available for future compensation to non-employee directors as of December 31, 2004. In February 2005, the Board of Directors elected to terminate the 1996 Director Plan. With the termination of the 1996 Director Plan, directors may elect each year to receive their annual retainer in cash, in common stock, or in a combination of both cash and common stock.

NOTE 25. COMMITMENTS AND CONTINGENCIES

In the course of its business the Company becomes involved in various claims, controversies, disputes and other contingent matters, including the items described in this Note. Some of these claims, controversies, disputes and other contingent matters involve litigation or other contested proceedings. With respect to these proceedings, the Company intends to vigorously protect and defend its interests and pursue its rights. However, no assurance can be given as to the ultimate outcome of any particular matter. In addition to issues specifically identified in this Note and with respect to matters that affect the regulated utility operations, the Company intends to seek, to the extent appropriate, regulatory approval of recovery of incurred costs through the ratemaking process.

Federal Energy Regulatory Commission Inquiry

On April 19, 2004, the FERC issued an order approving the contested Agreement in Resolution of Section 206 Proceeding (Agreement in Resolution) reached by Avista Corp. doing business as Avista Utilities, Avista Energy and the FERC's Trial Staff with respect to an investigation into the activities of Avista Utilities and Avista Energy in western energy markets during 2000 and 2001. In the Agreement in Resolution, the FERC Trial Staff stated that its investigation found: (1) no evidence that any executives or employees of Avista Utilities or Avista Energy knowingly engaged in or facilitated any improper trading strategy; (2) no evidence that Avista Utilities or Avista Energy engaged in any efforts to manipulate the western energy markets during 2000 and 2001; and (3) that Avista Utilities and Avista Energy did not withhold relevant information from the FERC's inquiry into the western energy markets for 2000 and 2001. As part of the Agreement in Resolution, Avista Utilities agreed to improve its system of taping energy trading conversations and its account settlement process. Avista Utilities and Avista Energy agreed to maintain an annual training program on the applicable FERC Code of Conduct for all employees engaged in the trading of electric energy and capacity. The Agreement in Resolution provides no remedial measures against Avista Utilities or Avista Energy and imposes no monetary remedies or penalties, and does not relinquish or modify Avista Energy's or Avista Utilities' market-based rate authority. On May 19, 2004, the City of Tacoma and California

Parties (the Office of the Attorney General, the California Public Utilities Commission (CPUC), and the California Electricity Oversight Board, filing jointly) filed requests for rehearing with respect to the FERC's April 19, 2004 order. On September 28, 2004, the State of Montana filed a motion to intervene in these proceedings citing evidence of alleged market manipulation by Avista Corp. and Avista Energy. The FERC's rulings on the rehearing requests and the State of Montana's motion to intervene are still pending. Based on the FERC's order approving the Agreement in Resolution, the Company does not expect that this proceeding will have any material effect on its financial condition, results of operations or cash flows.

Class Action Securities Litigation

On September 27, 2002, Ronald R. Wambolt filed a class action lawsuit in the United States District Court for the Eastern District of Washington against Avista Corp., Thomas M. Matthews, the former Chairman of the Board, President and Chief Executive Officer of the Company, Gary G. Ely, the current Chairman of the Board, President and Chief Executive Officer of the Company, and Jon E. Eliassen, the former Senior Vice President and Chief Financial Officer of the Company. In October and November 2002, Gail West, Michael Atlas and Peter Arnone filed similar class action lawsuits in the same court against the same parties. On February 3, 2003, the court issued an order consolidating the complaints under the name "In re Avista Corp. Securities Litigation," and on February 7, 2003 appointed the lead plaintiff and co-lead counsel. On August 19, 2003, the plaintiffs filed their consolidated amended class action complaint in the same court against the same parties. In their complaint, the plaintiffs continue to assert violations of the federal securities laws in connection with alleged misstatements and omissions of material fact pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The plaintiffs allege that the Company did not have adequate risk management processes, procedures and controls. The plaintiffs further allege that the Company engaged in unlawful energy trading practices and allegedly manipulated western power markets. The plaintiffs assert that alleged misstatements and omissions regarding these matters were made in the Company's filings with the Securities and Exchange Commission and other information made publicly available by the Company, including press releases. The class action complaint asserts claims on behalf of all persons who purchased, converted, exchanged or otherwise acquired the Company's common stock during the period between November 23, 1999 and August 13, 2002. The Company filed a motion to dismiss this complaint in October 2003 and the plaintiffs filed an answer to this motion in January 2004. Arguments before the Court on the motion were held on March 19, 2004. On April 15, 2004, the Court called for additional briefing on what effect, if any, the FERC proceedings (see "Federal Energy Regulatory Commission Inquiry" above) have on this case. On July 30, 2004, the Court denied the Company's motion to dismiss this complaint, holding, among other things, that the FERC proceedings may ultimately have some evidentiary value relevant to the disclosure issues raised in this case, but they do not preclude the resolution of those issues by the Court. In November 2004, the Company filed its answer to the complaint denying the plaintiffs' allegations. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Counterparty Defaults

In early 2001, California's two largest utilities defaulted on payment obligations owed to various energy sellers and market clearing organizations, including the California Power Exchange (CalPX) and the California Independent System Operator (CalISO). As a result, the CalPX and the CalISO defaulted on payment obligations owed to energy sellers, including Avista Energy, and the CalPX declared bankruptcy. In March 2002, Southern California Edison (SCE) paid its defaulted obligations, however the SCE funds were not cleared through the CalPX or the CalISO to energy sellers. In April 2004, Pacific Gas & Electric Company (PG&E) paid its defaulted obligations into an escrow fund in accordance with its bankruptcy reorganization. The FERC has ordered that the disbursement of these defaulted obligations held in the PG&E escrow fund and by the CalPX will depend on a determination of the California refund claims (see further information under "California Refund Proceeding"). The plan of reorganization for the CalPX bankruptcy also provides that disbursements to energy sellers or allowance of claims by energy purchasers depend on the FERC's order. As of December 31, 2004, Avista Energy's accounts receivable outstanding related to defaulting parties in California were fully offset by reserves for uncollected amounts and funds collected from defaulting parties. Avista Energy is pursuing recovery of the defaulted obligations. Because the resolution of these defaulted obligations by counterparties remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability for potential refunds beyond the defaulted obligations. However, based on information currently known to the Company's management, the Company does not expect that the resolution of these defaulted obligations will have a material adverse effect on its financial condition, results of

AVISTA CORPORATION

operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

California Refund Proceeding

In July 2001, the FERC initiated a proceeding to determine if refunds should be owed and, if so, the amounts of such refunds for sales during the period from October 2, 2000 to June 20, 2001 in the California power market. The order provides that any refunds owed could be offset against unpaid energy debts due to the same party. Interested parties have contested pricing determinants and other matters since the proceeding started. The CalISO and the CalPX prepared revised values for the affected power transactions and they are preparing additional iterations of revised prices and terms as directed by the FERC. The results of these calculations are likely to be appealed to the FERC and federal courts. In March 2003, the FERC issued an order that addressed issues related to the California refund proceedings, setting forth proposed retroactive pricing standards. The CalISO has estimated that it will finalize the initial calculation of the respective receivable/payable balances by the end of the first quarter of 2005, unless a further extension is granted. Many of the numerous orders that FERC has issued in the California refund proceedings are now on appeal before the United States Court of Appeals for the Ninth Circuit. In March 2004, the Ninth Circuit consolidated most of these appeals. The now consolidated appeals remain in abeyance pursuant to an August 2002 Ninth Circuit order directing the FERC to allow parties to file additional evidence on market manipulation. In addition, in June 2003, the FERC issued an order to review bids above \$250 per MW made by participants in the short-term energy markets operated by the CalISO and the CalPX from May 1, 2000 to October 2, 2000. Market participants with bids above \$250 per MW during the period described above have been required to demonstrate why their bidding behavior and practices did not violate applicable market rules. If violations were found to exist, the FERC would require the refund of any unjust profits and could also enforce other non-monetary penalties, such as the revocation of market-based rate authority. Avista Energy was subject to this review. In May 2004, the FERC provided notice that Avista Energy was no longer subject to this investigation. Because the resolution of the California refund proceeding remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that the California refund proceeding will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Pacific Northwest Refund Proceeding

In July 2001, the FERC initiated a preliminary evidentiary hearing to develop a factual record as to whether prices for spot market sales in the Pacific Northwest between December 25, 2000 to June 20, 2001 were just and reasonable. During the hearing, Avista Utilities and Avista Energy vigorously opposed claims that Pacific Northwest markets were dysfunctional, that rates for spot market sales were unjust and unreasonable and that the imposition of refunds would be appropriate. In September 2001, the FERC's Administrative Law Judge presiding over the evidentiary hearing issued a decision favorable to the Company's position and recommended that the FERC not order refunds and instead dismiss the entire proceeding. In June 2003, the FERC terminated the Pacific Northwest refund proceedings, after finding that the equities do not justify the imposition of refunds. In November 2003, the FERC affirmed its order. Seven petitions for review, including one filed by Puget Sound Energy, Inc. (Puget), are now pending before the United States Court of Appeals for the Ninth Circuit. Opening briefs were filed on January 14, 2005. Puget's brief is directed to the procedural flaws in the underlying docket. Puget argues that because its complaint was withdrawn as a matter of law in July 2001, the FERC erred in relying on it to serve as the basis to initiate the preliminary investigation into whether refunds for individually negotiated bilateral transactions in the Pacific Northwest were appropriate. On February 14, 2005, intervening parties, including Avista Energy and Avista Utilities, filed in support of Puget. Briefing is expected to be completed in the first half of 2005. Because the resolution of the Pacific Northwest refund proceeding remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that the Pacific Northwest refund proceeding will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Reliant Energy, Inc. and Duke Energy Corporation Cross-Complaints

In April 2002, several subsidiaries of Reliant Energy, Inc. (Reliant) and Duke Energy Corporation (Duke) filed cross-complaints against Avista Energy and numerous other participants in the California energy markets. The cross-complaints seek indemnification for any liability that may arise from original complaints filed against Reliant and Duke with respect to charges of unlawful and unfair business practices in the California energy markets under California law. In June 2002, Avista Energy filed motions to dismiss the cross-complaints. In the meantime, the

U.S. District Court remanded the case to California State Court, which remand is itself the subject of an appeal to the United States Court of Appeals for the Ninth Circuit. On December 8, 2004, the Ninth Circuit issued its opinion affirming the U.S. District Court's remand of these cases to California State Court, and a rehearing request was denied on March 3, 2005. Avista Energy intends to re-file the motion to dismiss, which was previously filed in U.S. District Court in June 2002, as a demurrer in California State Court. At this time, the Company cannot predict the outcome of the cross-complaints or the original complaints filed against Reliant and Duke or provide an estimate of any potential liability to Avista Energy with respect to the cross-complaints. However, based on information currently known to the Company's management, the Company does not expect that this matter will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

California Attorney General Complaint

In March 2002, the Attorney General of the State of California (California AG) filed a complaint with the FERC against certain specific companies (not including Avista Corp. or its subsidiaries) and "all other public utility sellers" in California. The complaint alleges that sellers with market-based rates have violated their tariffs by not filing with the FERC transaction-specific information about all of their sales and purchases at market-based rates. As a result, the California AG contends that all past sales should be subject to refund if found to be above just and reasonable levels. In May 2002, the FERC issued an order denying the claim to issue refunds. In July 2002, the California AG requested a rehearing on the FERC order, which request was denied in September 2002. Subsequently, the California AG filed a Petition for Review of the FERC's decision with the United States Court of Appeals for the Ninth Circuit. In September 2004, the United States Court of Appeals for the Ninth Circuit upheld the FERC's market-based rate authority, but remanded the case back to the FERC in order to determine whether transactional reporting under this authority was adequate, and what remedies would be appropriate for those not in compliance. In October 2004, Avista Energy joined with others in seeking rehearing of the Court's decision to remand the case back to the FERC for further proceedings. The Ninth Circuit has yet to rule on the request for rehearing. Based on information currently known to the Company's management, the Company does not expect that this matter will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Port of Seattle Complaint

In May 2003, a complaint was originally filed by the Port of Seattle in the United States District Court for the Western District of Washington against numerous companies, including Avista Corp., Avista Energy, Inc. and Avista Power, LLC (collectively the Avista defendants), seeking compensatory and treble damages for alleged violations of the Sherman Act and the Racketeer Influenced and Corrupt Organization Act by transmitting, via wire communications, false information intended to increase the price of power, knowing that others would rely upon such information. The complaint alleged that the defendants and others knowingly devised and attempted to devise a scheme to defraud and to obtain money and property from electricity customers throughout the Western Electricity Coordinating Council (WECC), by means of false and fraudulent pretenses, representations and promises. The alleged purpose of the scheme was to artificially increase the price that the defendants received for their electricity and ancillary services, to receive payments for services they did not provide and to manipulate the price of electricity throughout the WECC. In August 2003, the Avista defendants filed a motion to dismiss this complaint. A transfer order was granted, which moved this case to the United States District Court for the Southern District of California to consolidate it with other pending actions. Arguments with respect to the motions to dismiss filed by the Avista defendants and other defendants were heard on March 26, 2004. On May 12, 2004, the United States District Court for the Southern District of California granted motions to dismiss filed by the Avista defendants, as well as other defendants, with respect to this complaint. The Court dismissed the complaint because it determined that it was without jurisdiction to hear the plaintiff's claims, based on, among other things, the exclusive jurisdiction of the FERC and the filed-rate doctrine. On May 27, 2004, the Port of Seattle filed an appeal with the United States Court of Appeals for the Ninth Circuit. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

AVISTA CORPORATION

Wah Chang Complaint

On May 5, 2004, Wah Chang, a division of TDY Industries, Inc. (a subsidiary of Allegheny Technologies, Inc.), filed a complaint in the United States District Court for the District of Oregon against numerous companies, including Avista Corp., Avista Energy and Avista Power. The complaint seeks compensatory and treble damages for alleged violations of the Sherman Act, the Racketeer Influenced and Corrupt Organization Act, as well as violations of Oregon state law. According to the complaint, from September 1997 to September 2002, the plaintiff purchased electricity from PacifiCorp pursuant to a contract that was indexed to the spot wholesale market price of electricity. The plaintiff alleges that the defendants, acting in concert among themselves and/or with Enron Corporation and certain affiliates thereof (collectively, Enron) and others, engaged in a scheme to defraud electricity customers by transmitting false market information in interstate commerce in order to artificially increase the price of electricity provided by them, to receive payment for services not provided by them and to otherwise manipulate the market price of electricity, and by executing wash trades and other forms of market manipulation techniques and sham transactions. The plaintiff also alleges that the defendants, acting in concert among themselves and/or with Enron and others, engaged in numerous practices involving the generation, purchase, sale, exchange, scheduling and/or transmission of electricity with the purpose and effect of causing a shortage (or the appearance of a shortage) in the generation of electricity and congestion (or the appearance of congestion) in the transmission of electricity, with the ultimate purpose and effect of artificially and illegally fixing and raising the price of electricity in California and throughout the Pacific Northwest. As a result of the defendants' alleged conduct, the plaintiff allegedly suffered damages of not less than \$30 million through the payment of higher electricity prices. In September 2004, this case was transferred to the United States District Court for the Southern District of California for consolidation with other pending actions. In October 2004, the Avista defendants joined with other defendants in filing a joint motion to dismiss the complaint. In February 2005, the Court dismissed the complaint because it determined that it was without jurisdiction to hear the plaintiff's complaint, based on, among other things, the exclusive jurisdiction of the FERC and the filed-rate doctrine. The Court's decision is subject to appeal. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

City of Tacoma Complaint

On June 7, 2004, the City of Tacoma, Department of Public Utilities, Light Division, a Washington municipal corporation (Tacoma Power), filed a complaint in the United States District Court for the Western District of Washington against over fifty companies, including Avista Corp., Avista Energy and Avista Power. According to the complaint, Tacoma Power distributes electricity to customers in Tacoma, and Pierce County, Washington, generates electricity at several facilities in western Washington and purchases power under supply contracts and in the Northwest spot market. Tacoma Power's complaint seeks compensatory and treble damages from alleged violations of the Sherman Act. Tacoma Power alleges that the defendants, acting in concert, engaged in a pattern of activities that had the purpose and effect of creating the impressions that the demand for power was higher, the supply of power was lower, or both, than was in fact the case. This allegedly resulted in an artificial increase of the prices paid for power sold in California and elsewhere in the western United States during the period from May 2000 through the end of 2001. Due to the alleged unlawful conduct of the defendants, Tacoma Power allegedly paid an amount estimated to be \$175.0 million in excess of what it would have paid in the absence of such alleged conduct. In September 2004, this case was transferred to the United States District Court for the Southern District of California for consolidation with other pending actions. In February 2005, the Court granted the defendants' motion to dismiss this complaint for similar reasons to those expressed by the Court in the Wah Chang complaint described above. The Court's decision is subject to appeal. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Public Utility District No. 1 of Snohomish County

On November 5, 2004, Public Utility District No. 1 of Snohomish County filed a Petition For a Writ of Certiorari with the United States Supreme Court, requesting the Court to consider whether the filed rate doctrine applies for market-based rates so as to preempt state law antitrust and consumer fraud actions based upon alleged fraud and manipulation of electricity markets operated under market-based rate tariffs. This petition seeks review of the decision of the United States Court of Appeals for the Ninth Circuit on September 10, 2004, which held that the filed

rate doctrine and field and conflict preemptions bar such actions. Seventeen states have urged the United States Supreme Court to grant the petition. On February 22, 2005, the Court invited the Solicitor General to provide the Court with the views of the United States. Although, this case does not directly involve Avista Corp. and its subsidiaries, the outcome could have a bearing on pending litigation and regulatory proceedings affecting Avista Corp. and its subsidiaries discussed above.

State of Montana Proceedings

On June 30, 2003, the Attorney General of the State of Montana (Montana AG) filed a complaint in the Montana District Court on behalf of the people of Montana and the Flathead Electric Cooperative, Inc. against numerous companies, including Avista Corp. The complaint alleges that the companies illegally manipulated western electric and natural gas markets in 2000 and 2001. This case was subsequently moved to the United States District Court for the District of Montana; however, it has since been remanded back to the Montana District Court. No further action has been made with respect to this complaint.

The Montana AG also petitioned the Montana Public Service Commission (MPSC) to fine public utilities \$1,000 a day for each day it finds they engaged in alleged "deceptive, fraudulent, anticompetitive or abusive practices" and order refunds when consumers were forced to pay more than just and reasonable rates. On February 12, 2004, the MPSC issued an order initiating investigation of the Montana retail electricity market for the purpose of determining whether there is evidence of unlawful manipulation of that market. The Montana AG has requested specific information from Avista Energy and Avista Corp. regarding their transactions within the State of Montana during the period from January 1, 2000 through December 31, 2001.

Because the resolution of these proceedings remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that these proceedings will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Montana Public School Trust Fund Lawsuit

In October 2003, a lawsuit was filed by Richard Dolan and Denise Hayman in the United States District Court for the District of Montana against all private owners of hydroelectric dams in Montana, including Avista Corp. The lawsuit alleges that the hydroelectric facilities are located on state-owned riverbeds and the owners have never paid compensation to the state's public school trust fund. The lawsuit requests lease payments dating back to the construction of the respective dams and also requests damages for trespassing and unjust enrichment. An Amended Complaint adding Great Falls Elementary School District No. 1 and Great Falls High School District 1A was filed on January 16, 2004. On February 2, 2004, the Company filed its motion to dismiss this lawsuit; PacifiCorp and PPL Montana, as the other named defendants also filed a motion to dismiss, or joined therein. On May 10, 2004, the Montana AG filed a complaint on behalf of the state to join in this lawsuit to allegedly protect and preserve state lands/school trust lands from use without compensation. On July 19, 2004, the defendants (including Avista Corp.) filed a motion to dismiss the Montana AG's complaint. On September 29, 2004, the Court granted the motion to dismiss filed with respect to plaintiffs Richard Dolan, Denise Hayman and the school districts. However, the motion to dismiss the Montana AG's complaint was denied, citing, among other things, that the FERC does not have exclusive jurisdiction over this matter. On November 12, 2004, the defendants (including Avista Corp.) filed a petition for declaratory relief in Montana State Court requesting the resolution of the controversy that the plaintiffs raised in federal court. On November 24, 2004, the Montana AG filed an answer, counterclaim and motion for summary judgment. The defendants have filed responses to the Montana AG's motion for summary judgment. The Montana State Court has not scheduled a hearing on the motions. Subsequently, in response to the motions of the defendants, the federal magistrate judge on January 19, 2005, filed recommendations that the federal court order on the merits be vacated based on lack of jurisdiction of the Court. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Colstrip Generating Project Complaint

In May 2003, various parties (all of which are residents or businesses of Colstrip, Montana) filed a consolidated complaint against the owners of the Colstrip Generating Project (Colstrip) in Montana District Court. Avista Corp. owns a 15 percent interest in Units 3 & 4 of Colstrip. The plaintiffs allege damages to buildings as a result of rising

AVISTA CORPORATION

ground water, as well as damages from contaminated waters leaking from the lakes and ponds of Colstrip. The plaintiffs are seeking punitive damages, an order by the court to remove the lakes and ponds and the forfeiture of all profits earned from the generation of Colstrip. The Company intends to work with the other owners of Colstrip in defense of this complaint. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Environmental Protection Agency Administrative Compliance Order

In December 2003, PPL Montana, LLC, as operator of Colstrip, received an Administrative Compliance Order (ACO) from the Environmental Protection Agency (EPA) pursuant to the Clean Air Act (CAA). The ACO alleges that Colstrip Units 3 & 4 have been in violation of the CAA permit at Colstrip since 1980. The permit required Colstrip to submit for review and approval by the EPA an analysis and proposal for reducing emissions of nitrogen oxides to address visibility concerns if, and when, EPA promulgates Best Available Retrofit Technology requirements for nitrogen oxide emissions. The EPA is asserting that regulations it promulgated in 1980 triggered this requirement. Avista Utilities and PPL Montana, LLC believe that the ACO is unfounded and PPL Montana, LLC is discussing the matter with the EPA. The ACO does not expressly seek penalties, and it is unclear at this time what, if any, additional control technology the EPA may consider to be required. Accordingly, the costs to install any additional controls for nitrogen oxides, if required, cannot be estimated at this time. In addition, the Montana Department of Environmental Quality (Montana DEQ) is questioning whether the permit limits for sulfur dioxide emissions from Colstrip Units 3 & 4 are too high under provisions of the CAA that limit allowable emissions from sources built after 1978. The owners of Colstrip are engaged in settlement negotiations on these matters with the EPA, the Montana DEQ and the Northern Cheyenne Tribe. Because the resolution of this issue remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this issue will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Colstrip Royalty Claim

The Western Energy Company (WECO) supplies coal to the owners of Colstrip Units 3 & 4 under a Coal Supply Agreement and a Transportation Agreement. The Minerals Management Service (MMS) of the United States Department of the Interior issued an order to WECO to pay additional royalties concerning coal delivered to Colstrip Units 3 & 4 via the conveyor belt (approximately 4.46 miles long) that is subject to reimbursement for certain costs under the Transportation Agreement. The owners of Colstrip Units 3 & 4 take delivery of the coal at the western end (beginning) of the conveyor belt. The order asserts that additional royalties are owed MMS as a result of WECO not paying royalties in connection with revenue received by WECO from the owners of Colstrip Units 3 & 4 under the Transportation Agreement during the period October 1, 1991 through December 31, 2001. WECO has appealed the order and the appeal process could take up to five years to resolve. The owners of Colstrip Units 3 & 4 are monitoring the appeal process between WECO and MMS.

WECO has indicated to the owners of Colstrip Units 3 & 4 that if WECO is unsuccessful in the appeal process, WECO will seek reimbursement of any royalty payments by passing these costs through the Coal Supply Agreement. The owners of Colstrip Units 3 & 4 advised WECO that their position would be that these claims are not allowable costs per the Coal Supply Agreement nor the Transportation Agreement in the event the owners of Colstrip Units 3 & 4 were invoiced for these claims. Because the resolution of this issue remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this issue will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Hamilton Street Bridge Site

A portion of the Hamilton Street Bridge Site in Spokane, Washington (including a former coal gasification plant site that operated for approximately 60 years until 1948) was acquired by the Company through a merger in 1958. The Company no longer owns the property. In January 1999, the Company received notice from the State of Washington's Department of Ecology (DOE) that it had been designated as a potentially liable party (PLP) with

respect to any hazardous substances located on this site, stemming from the Company's past ownership of the former gas plant site. In its notice, the DOE stated that it intended to complete an on-going remedial investigation of this site, complete a feasibility study to determine the most effective means of halting or controlling future releases of substances from the site, and to implement appropriate remedial measures. The Company responded to the DOE acknowledging its listing as a PLP, but requested that additional parties also be listed as PLPs. In the spring of 1999, the DOE named two other parties as additional PLPs.

The DOE, the Company and another PLP, Burlington Northern & Santa Fe Railway Co. (BNSF) signed an Agreed Order in March 2000 that provided for the completion of a remedial investigation and a feasibility study. The work to be performed under the Agreed Order includes three major technical parts: completion of the remedial investigation; performance of a focused feasibility study; and implementation of an interim groundwater monitoring plan. During the second quarter of 2000, the Company received comments from the DOE on its initial remedial investigation, and then submitted another draft of the remedial investigation, which was accepted as final by the DOE. After responding to comments from the DOE, the feasibility study was accepted by the DOE during the fourth quarter of 2000. After receiving input from the Company and the other PLPs, the final Cleanup Action Plan (CAP) was issued by the DOE in August 2001. In September 2001, the DOE issued an initial draft Consent Decree for the PLPs to review. During the first quarter of 2002, the Company and BNSF signed a cost sharing agreement. In September 2002, the Company, BNSF and the DOE finalized the Consent Decree to implement the CAP. The third PLP has indicated it will not sign the Consent Decree. It is currently estimated that the Company's share of the costs will be less than \$1.0 million. The Engineering and Design Report for the CAP was submitted to the DOE in January 2003 and approved by the DOE in May 2003. Work under the CAP commenced during the second quarter of 2003. In September 2004, a Site Preparation Agreement was reached with the third PLP with respect to the logistics of the CAP. Under this agreement, the third PLP will have the site preparation completed by mid-2005 and work under the CAP will be completed by late 2005.

Spokane River

In March 2001, the DOE informed Avista Development, a subsidiary of Avista Capital, of a health advisory concerning PCBs found in fish caught in a portion of the Spokane River. In June 2001, Avista Development received official notice that it had been designated as a PLP with respect to contaminated sites on the Spokane River. The DOE discovered PCBs in fish and sediments in the Spokane River in the 1970s and 1980s. In the 1990s, the DOE performed subsequent sampling of the river and identified potential sources of the PCBs, including the Spokane Industrial Park (SIP) and a number of other entities in the area. The SIP, renamed Pentzer Development Corporation (Pentzer Development) in 1990, operated a wastewater treatment plant at the site until it was closed in December 1993. The SIP's treatment plant discharged to the Spokane River under the terms of a National Pollutant Discharge Elimination System permit issued by the DOE. Pentzer Development sold the property in 1996 and merged with Avista Development in 1998. Avista Development filed a response to this notice in August 2001. In December 2001, the DOE confirmed Avista Development's status as a PLP and named at least two other PLPs in this matter. In April 2003, the DOE released its study of wastewater and sludge handling from facilities owned by a fourth PLP. The DOE study indicated that the fourth PLP continued to discharge PCBs into the Spokane River. The DOE issued the fourth PLP a final notice of participation as a PLP on April 30, 2003.

During the fourth quarter of 2002, Avista Development and one other PLP, Kaiser Aluminum & Chemical Corporation (Kaiser), finalized the Consent Decree and Scope of Work for the remedial investigation and feasibility study of the site, which was formally entered into Spokane County Superior Court in January 2003. The other PLPs have not been participating in the process. As directed by Avista Development and Kaiser, the field-work for the remedial investigation began in April 2003 and was completed by the end of 2003 with a draft remedial investigation report and feasibility study technical memorandum submitted to the DOE in March 2004. In December 2004, the Company and Kaiser filed the draft final remedial investigation and feasibility study with the DOE. In February 2005, the DOE issued its draft Cleanup Action Plan (CAP), which is expected to be presented for public review and comment, along with the remedial investigation and feasibility study, in March 2005. Kaiser has filed for bankruptcy and is expected to file its reorganization plan in the first half of 2005. Kaiser continues to have negotiations with the DOE and Avista Development to settle its future financial liabilities associated with the site.

The Company has estimated its probable liability and has accrued this amount during 2004, which was not material to the Company's consolidated financial condition or results of operations. However, because of uncertainties with respect to, among other things, the final cost sharing agreement between the PLPs, Kaiser's bankruptcy and the final cleanup action plan required by the DOE, the Company's estimate of its liability could change in future periods. Based on information currently known to the Company's management, the Company does not believe that such a

AVISTA CORPORATION

change would be material to its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimate of the liability. Such a change, should it occur, could be significant.

Lake Coeur d'Alene

In July 1998, the United States District Court for the District of Idaho issued its finding that the Coeur d'Alene Tribe of Idaho (Tribe) owns, among other things, portions of the bed and banks of Lake Coeur d'Alene (Lake) lying within the current boundaries of the Coeur d'Alene Reservation. This action had been brought by the United States on behalf of the Tribe against the state of Idaho. The Company was not a party to this action. The United States District Court decision was affirmed by the United States Court of Appeals for the Ninth Circuit. The United States Supreme Court affirmed this decision in June 2001. This will result in, among other things, the Company being liable to the Tribe for compensation for the use of reservation lands under Section 10(e) of the Federal Power Act.

The Company's Post Falls Hydroelectric Generating Station (Post Falls), a facility constructed in 1906 with a present capability of 18 MW, utilizes a dam on the Spokane River downstream of the Lake which controls the water level in the Lake for portions of the year (including portions of the lakebed owned by the Tribe). The Company has other hydroelectric facilities on the Spokane River downstream of Post Falls, but these facilities do not affect the water level in the Lake. The Company and the Tribe are engaged in discussions with respect to past and future compensation (which may include interest) for use of the portions of the bed and banks of the Lake, which are owned by the Tribe. If the parties cannot agree on the amount of compensation, the matter could result in litigation. The Company cannot predict the amount of compensation that it will ultimately pay or the terms of such payment. However, the Company intends to seek recovery of any amounts paid through the rate making process.

Spokane River Relicensing

The Company operates six hydroelectric plants on the Spokane River, and five of these (Long Lake, Nine Mile, Upper Falls, Monroe Street and Post Falls) are under one FERC license and referred to herein as the Spokane River Project. The sixth, Little Falls, is operated under separate Congressional authority and is not licensed by the FERC. The license for the Spokane River Project expires in August 2007; the Company filed a Notice of Intent to Relicense in July 2002. The formal consultation process involving planning and information gathering with stakeholder groups has been underway since that time. The Company's goal is to develop with the stakeholders a comprehensive and cost-effective settlement agreement to be filed as part of the Company's license application to the FERC in July 2005. The Company provided a Draft License Application for public comment in February 2005. The Company intends to seek recovery of relicensing costs through the rate making process.

Clark Fork Settlement Agreement

Dissolved atmospheric gas levels exceed state of Idaho and federal water quality standards downstream of the Cabinet Gorge Hydroelectric Generating Project (Cabinet Gorge) during periods when excess river flows must be diverted over the spillway. Under the terms of the Clark Fork Settlement Agreement, the Company developed an abatement and mitigation strategy with the other signatories to the agreement and submitted the Gas Supersaturation Control Program (GSCP) in December 2002 for review and approval to the Idaho Department of Environmental Quality (DEQ) and the U.S. Fish and Wildlife Service. In February 2004, the Idaho DEQ and the U.S. Fish and Wildlife Service approved the GSCP. In January 2005, the FERC issued an order approving the GSCP. The GSCP provides for the opening and modification of one and, potentially, both of the two existing diversion tunnels built when Cabinet Gorge was originally constructed. Streamflows would be diverted to the tunnels when these flows are in excess of turbine capacity. The cost of modifying the first tunnel is currently preliminarily estimated to be \$38 million (including AFUDC and inflation) and would be incurred between 2004 and 2010, with the majority of these costs being incurred in 2007 through 2009. The second tunnel would be modified only after evaluation of the performance of the first tunnel and such modifications would commence no later than 10 years following the completion of the first tunnel. It is currently preliminarily estimated that the costs to modify the second tunnel would be \$26 million (including AFUDC and inflation). As part of the GSCP, the Company provides \$0.5 million annually as mitigation for aquatic resources that might be adversely affected by high dissolved gas levels. Mitigation funds will continue until the modification of the second tunnel commences or if the second tunnel is not modified to an agreed upon point in time commensurate with the biological effects of high dissolved gas levels. The Company intends to seek recovery of the costs for the modification of Cabinet Gorge and the mitigation payments through the rate making process.

The operating license for the Clark Fork Project describes the approach to restore bull trout populations in the project areas. Using the concept of adaptive management and working closely with the U.S. Fish and Wildlife Service, the Company is evaluating the feasibility of fish passage. The results of these studies will help the Company and other parties determine the best use of funds toward continuing fish passage efforts or other fish population

enhancement measures.

Other Contingencies

In the normal course of business, the Company has various other legal claims and contingent matters outstanding. The Company believes that any ultimate liability arising from these actions will not have a material adverse impact on the Company's financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

The Company routinely assesses, based on in-depth studies, expert analyses and legal reviews, its contingencies, obligations and commitments for remediation of contaminated sites, including assessments of ranges and probabilities of recoveries from other responsible parties who have and have not agreed to a settlement and recoveries from insurance carriers. The Company's policy is to accrue and charge to current expense identified exposures related to environmental remediation sites based on estimates of investigation, cleanup and monitoring costs to be incurred.

The Company has potential liabilities under the Federal Endangered Species Act for species of fish that have either already been added to the endangered species list, been listed as "threatened" or been petitioned for listing. Thus far, measures adopted and implemented have had minimal impact on the Company.

Under the federal licenses for its hydroelectric projects, the Company is obligated to protect its property rights, including water rights. The State of Montana is examining the status of all water right claims within state boundaries. Claims within the Clark Fork River basin could potentially adversely affect the energy production of the Company's Cabinet Gorge and Noxon Rapids hydroelectric facilities. The Company is participating in this extensive adjudication process, which is unlikely to be concluded in the foreseeable future.

The Company must be in compliance with requirements under the Clean Air Act Amendments at the Colstrip thermal generating plant, in which the Company maintains an ownership interest. The anticipated share of costs at Colstrip is not expected to have a major economic impact on the Company.

As of December 31, 2004, the Company's collective bargaining agreement with the International Brotherhood of Electrical Workers represented approximately 50 percent of all Avista Utilities employees. The current agreement with the local union representing the majority (approximately 90 percent) of the bargaining unit employees expires on March 25, 2005. A local agreement in the South Lake Tahoe area, which represents 5 employees, also expires on March 25, 2005. Two local agreements in Oregon, which cover approximately 50 employees, will expire on March 31, 2005. Another local agreement in Oregon is not up for negotiations until 2007. Negotiations are currently ongoing with respect to the labor agreements that expire in March 2005.

NOTE 26. INFORMATION SERVICES CONTRACTS

The Company has information services contracts that expire between 2006 and 2012. Total payments under these contracts were \$12.8 million, \$12.0 million and \$9.7 million in 2004, 2003 and 2002, respectively. The majority of these costs are included in administrative and general expenses in the Consolidated Statements of Income. Minimum contractual obligations under the Company's information services contracts are approximately \$12.4 million in 2005, \$12.1 million in 2006 and \$10.8 million per year from 2007 through 2012. The most significant of these contracts provides for increases due to changes in the cost of living index and further provides flexibility in the annual obligation from year-to-year subject to a three-year true-up cycle.

NOTE 27. DISPOSITION OF SOUTH LAKE TAHOE PROPERTIES

In July 2004, Avista Corp. reached an agreement to sell its South Lake Tahoe natural gas distribution properties to Southwest Gas Corporation as part of Avista Utilities' strategy to focus on its business in the northwestern United States. The agreed upon cash purchase price for the properties is approximately \$15 million, subject to closing adjustments. In February 2005, a CPUC Administrative Law Judge issued a draft order, subject to comment, that authorizes the proposed purchase and sale agreement under the terms of a settlement agreement among the parties to the CPUC proceedings. The agreement is subject to customary closing conditions, as well as regulatory review and approval by the CPUC. Final approval of the transaction has been placed on the CPUC's meeting agenda for possible action on March 17, 2005. The Company expects the sale to be completed in the first half of 2005.

AVISTA CORPORATION

As of December 31, 2004, Avista Utilities serviced approximately 18,750 customers (or 6 percent of total natural gas customers) in the South Lake Tahoe region. Total revenues for 2004 from the South Lake Tahoe region were approximately \$20.3 million (or 6 percent of total natural gas revenues) and approximately 22.1 million therms were delivered (or 4 percent of total therms delivered) to South Lake Tahoe customers.

The Company has classified the assets of its South Lake Tahoe natural gas distribution properties as assets held for sale on the Consolidated Balance Sheet as of December 31, 2004. These assets consist primarily of net utility property, accounts receivable and deferred natural gas costs.

NOTE 28. ACQUISITION OF REMAINING INTEREST IN COYOTE SPRINGS 2

In January 2005, Avista Corp. completed the acquisition of Mirant Oregon LLC's 50 percent ownership interest in Coyote Springs 2 at a price of \$62.5 million. Mirant Oregon LLC acquired an indirect 50 percent ownership interest in Coyote Springs 2 from the Company during construction in 2001.

NOTE 29. SELECTED QUARTERLY FINANCIAL DATA (Unaudited)

The Company's energy operations are significantly affected by weather conditions. Consequently, there can be large variances in revenues, expenses and net income between quarters based on seasonal factors such as temperatures and streamflow conditions. During the second quarter of 2003, Avista Corp. reported Avista Labs as discontinued operations (see Note 3). Accordingly, periods prior to the second quarter of 2003 have been restated to reflect Avista Labs as discontinued operations. Several accounting standards have been issued and rescinded, which have changed the accounting and reporting for derivative commodity instruments. This has resulted in the restatement of operating revenues and resource costs (operating expenses) for periods prior to the issuance or rescission of the respective accounting standards. Such restatements have not had any impact on income from operations, income from continuing operations, net income or income available for common stock. A summary of quarterly operations (in thousands, except per share amounts) for 2004 and 2003 follows:

	Three Months Ended			
	March 31	June 30	September 30	December 31
2004				
Operating revenues.....	\$343,732	\$225,888	\$241,552	\$340,408
Operating expenses:				
Resource costs	198,954	92,411	133,312	180,307
Operations and maintenance	38,054	36,361	42,588	38,941
Administrative and general	25,496	24,769	26,479	27,521
Depreciation and amortization	17,682	20,631	20,458	19,655
Taxes other than income taxes	<u>20,339</u>	<u>15,129</u>	<u>14,170</u>	<u>17,853</u>
Total operating expenses	<u>300,525</u>	<u>189,301</u>	<u>237,007</u>	<u>284,277</u>
Income from operations	<u>43,207</u>	<u>36,587</u>	<u>4,545</u>	<u>56,131</u>
Net income (loss) before cumulative effect of accounting change	12,684	10,132	(9,782)	22,580
Cumulative effect of accounting change	<u>(460)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net income (loss)	12,224	10,132	(9,782)	22,580
Income (loss) available for common stock	\$12,224	\$10,132	\$(9,782)	\$22,580
Outstanding common stock:				
Weighted average	48,352	48,384	48,416	48,446
End of period	49,038	48,881	48,416	48,935
Earnings (loss) per share, diluted:				
Earnings (loss) per share before cumulative effect of accounting change	\$0.26	\$0.21	\$(0.20)	\$0.46
Cumulative effect of accounting change	<u>(0.01)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total earnings (loss) per share, diluted	<u>\$0.25</u>	<u>\$0.21</u>	<u>\$(0.20)</u>	<u>\$0.46</u>
Dividends paid per common share	\$0.125	\$0.13	\$0.13	\$0.13
Trading price range per common share:				
High	\$18.92	\$19.17	\$18.56	\$18.55
Low	\$17.55	\$15.51	\$16.95	\$16.95

AVISTA CORPORATION

	Three Months Ended			
	March 31	June 30	September 30	December 31
2003				
Operating revenues.....	\$338,892	\$236,735	\$238,750	\$309,008
Operating expenses:				
Resource costs	185,916	102,309	122,591	165,676
Operations and maintenance	33,323	33,459	31,722	39,554
Administrative and general	27,863	22,684	22,780	24,167
Depreciation and amortization	18,942	18,904	20,114	19,851
Taxes other than income taxes	17,858	15,270	13,424	15,275
Total operating expenses	<u>283,902</u>	<u>192,626</u>	<u>210,631</u>	<u>264,523</u>
Income from operations.....	54,990	44,109	28,119	44,485
Income from continuing operations.....	18,442	12,713	4,386	15,102
Loss from discontinued operations.....	(1,120)	(3,744)	(66)	(19)
Net income before cumulative effect of accounting change	17,322	8,969	4,320	15,083
Cumulative effect of accounting change.....	(1,190)	-	-	-
Net income	16,132	8,969	4,320	15,083
Income available for common stock.....	\$15,554	\$8,422	\$4,320	\$15,083
Outstanding common stock:				
Weighted average	48,100	48,224	48,281	48,319
End of period	48,182	47,830	48,311	48,344
Earnings per share, diluted:				
Earnings per share from continuing operations.....	\$0.37	\$0.25	\$0.09	\$0.31
Loss per share from discontinued operations.....	(0.02)	(0.08)	-	-
Earnings per share before cumulative effect of accounting change	0.35	0.17	0.09	0.31
Cumulative effect of accounting change	(0.03)	-	-	-
Total earnings per share, diluted.....	<u>\$0.32</u>	<u>\$0.17</u>	<u>\$0.09</u>	<u>\$0.31</u>
Dividends paid per common share	\$0.12	\$0.12	\$0.125	\$0.125
Trading price range per common share:				
High	\$12.65	\$14.80	\$16.53	\$18.70
Low	\$9.80	\$10.49	\$13.91	\$15.55

MANAGEMENT'S REPORTS TO AVISTA CORPORATION STOCKHOLDERS

Management's Statement of Responsibility

Management of Avista Corporation is responsible for the accuracy and completeness of the information in this annual report. The financial and operating information presented is derived from company records and other sources. This annual report includes amounts that are based on judgment and estimates where necessary. Disclosure controls and procedures in combination with the Company's internal control over financial reporting provide reasonable assurance that the annual report fairly and reasonably presents the Company's financial position and operating results.

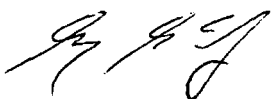
Management's Report on Internal Control Over Financial Reporting

The Company's management, together with its consolidated subsidiaries, is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934). The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive officer and principal financial officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with accounting principals generally accepted in the United States of America.

Under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, the Company conducted an assessment of the effectiveness of the Company's internal control over financial reporting based on the framework established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2004 is effective.

The Company's internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principals generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the Company's financial statements.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004 has been audited by Deloitte & Touche LLP, the independent registered public accounting firm who audits the Company's consolidated financial statements, as stated in their reports on the following pages, which expresses unqualified opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting as of December 31, 2004.



Gary G. Ely
*Chairman, President and
Chief Executive Officer*



Malyn K. Malquist
*Senior Vice President,
Chief Financial Officer
and Treasurer*

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Avista Corporation and subsidiaries
Spokane, Washington

We have audited the accompanying consolidated balance sheets of Avista Corporation and subsidiaries (the "Company") as of December 31, 2004 and 2003, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows, which include the schedule of information by business segments, for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Avista Corporation and subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the consolidated financial statements ("Note 2"), during 2004, the Company was required to consolidate a partnership as well as several low-income housing project investments related to the adoption of Financial Accounting Standards Board ("FASB") Interpretation No. 46(R). Additionally, during 2003, as described in Note 1 to the consolidated financial statements ("Note 1"), the Company changed its method of accounting for energy trading activities related to the transition from Emerging Issues Task Force Issue No. 98-10 to Statement of Financial Accounting Standards ("SFAS") No. 133, and, as described in Note 2, was required to consolidate WP Funding LP, and deconsolidate the capital trusts related to the adoption of FASB Interpretation No. 46. Additionally, as described in Note 2, during 2003, the Company changed its classification of preferred stock to conform to the requirements of SFAS No. 150. Additionally, as described in Note 1 to the consolidated financial statements, during 2002, the Company changed its method of accounting for goodwill to conform to SFAS No. 142.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 9, 2005 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

Seattle, Washington
March 9, 2005

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Avista Corporation and subsidiaries
Spokane, Washington

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Avista Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

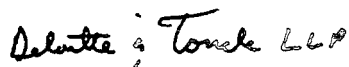
We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2004 of the Company, and our report dated March 9, 2005 expressed an unqualified opinion on those financial statements and included an explanatory paragraph for certain changes in accounting and presentation resulting from the impact of recently adopted accounting standards.



Seattle, Washington
March 9, 2005

SELECTED FINANCIAL DATA

	2004	2003	2002	2001	2000	1999
FINANCIAL RESULTS						
Operating revenues	\$1,151,580	\$1,123,385	\$1,062,916	\$1,511,751	\$1,935,479	\$670,000
Operating expenses	1,011,110	951,682	905,774	1,327,685	1,706,449	515,000
Income from operations	140,470	171,703	157,142	184,066	229,030	155,000
Interest expense	93,047	92,985	104,866	105,819	68,255	53,000
Income taxes	21,592	35,340	34,849	40,585	81,143	44,000
Income from continuing operations	35,614	50,643	42,174	68,241	109,065	77,000
Loss from discontinued operations	-	(4,949)	(6,719)	(56,085)	(17,386)	-
Net income before cumulative effect of accounting change	35,614	45,694	35,455	12,156	91,679	77,000
Cumulative effect of accounting change	(460)	(1,190)	(4,148)	-	-	-
Net income	35,154	44,504	31,307	12,156	91,679	77,000
Preferred stock dividend requirements (1)	-	1,125	2,402	2,432	23,735	8,000
Income available for common stock	\$35,154	\$43,379	\$28,905	\$9,724	\$67,944	\$68,000
Earnings per common share, diluted:						
Avista Utilities	\$0.67	\$0.72	\$0.71	\$0.46	\$(1.37)	\$-
Energy Marketing and Resource Management	0.20	0.43	0.47	1.33	3.51	\$-
Avista Advantage	0.01	(0.03)	(0.09)	(0.23)	(0.23)	\$-
Other	(0.15)	(0.10)	(0.26)	(0.18)	(0.06)	\$-
Earnings per common share from continuing operations	\$0.73	\$1.02	\$0.83	\$1.38	\$1.85	\$-
Loss per common share from discontinued operations	-	(0.10)	(0.14)	(1.18)	(0.38)	\$-
Earnings per common share before cumulative effect of accounting change	0.73	0.92	0.69	0.20	1.47	\$-
Loss per common share from cumulative effect of accounting change	(0.01)	(0.03)	(0.09)	-	-	\$-
Total earnings per common share, diluted	\$0.72	\$0.89	\$0.60	\$0.20	\$1.47	\$-
Total earnings per common share, basic	\$0.73	\$0.90	\$0.60	\$0.21	\$1.49	\$-
COMMON STOCK STATISTICS						
Dividends paid per common share	\$0.515	\$0.49	\$0.48	\$0.48	\$0.48	\$-
Book value per common share	\$15.54	\$15.54	\$14.84	\$15.12	\$15.34	\$11.00
Shares of common stock:						
Outstanding at year-end	48,472	48,344	48,044	47,633	47,209	54,000
Average - basic	48,400	48,232	47,823	47,417	45,690	53,000
Average - diluted	48,886	48,630	47,874	47,435	46,103	53,000
Return on average common equity:						
Total company	4.7%	5.9%	4.0%	1.3%	12.9%	1.0%
Utility only	6.6%	7.4%	8.2%	5.9%	-23.7%	-
Non-utility only	1.0%	3.2%	-1.7%	-3.4%	44.1%	1.0%
Common stock price:						
High	\$19.17	\$18.70	\$16.60	\$23.97	\$68.00	\$11.00
Low	\$15.51	\$9.80	\$8.75	\$10.60	\$14.63	\$11.00
Year-end close	\$17.67	\$18.12	\$11.56	\$13.26	\$20.50	\$11.00
DEBT AND PREFERRED STOCK STATISTICS						
Pretax interest coverage:						
Including AFUDC/AFUCE	1.60(x)	1.78(x)	1.59(x)	1.32(x)	2.35(x)	3.0(x)
Excluding AFUDC/AFUCE	1.56(x)	1.76(x)	1.57(x)	1.29(x)	2.32(x)	3.0(x)
Embedded cost of long-term debt	8.27%	8.44%	8.88%	8.78%	7.40%	7.00%
Embedded cost of preferred stock	7.39%	7.35%	7.42%	7.39%	7.39%	7.00%
Credit Ratings (Standard & Poor's/Moody's)						
Senior secured debt	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa1	A-
Senior unsecured debt	BB+/Ba1	BB+/Ba1	BB+/Ba1	BB+/Ba1	BBB-/Baa2	BBB+/Baa1
Preferred stock	BB-/Ba3	BB-/Ba3	BB-/Ba3	BB-/Ba3	BBB-/Baa3	BBB+/Baa1
FINANCIAL CONDITION						
Total assets	\$3,703,823	\$3,640,075	\$3,799,543	\$4,210,704	\$12,739,511	\$1,994,000
Total net utility property	1,956,063	1,914,001	1,749,114	1,739,123	1,680,742	1,329,000
Utility property capital expenditures (excluding AFUDC)	115,346	102,271	64,207	119,905	98,680	122,000
Long-term debt	901,556	925,012	902,635	1,175,715	679,806	721,000
Long-term debt to affiliated trusts (2)	113,403	113,403	-	-	-	-
Preferred trust securities (2)	-	-	100,000	100,000	100,000	-
Preferred stock subject to mandatory redemption (1)	28,000	29,750	33,250	35,000	35,000	135,000
Common equity	\$753,205	\$751,252	\$712,791	\$720,063	\$724,224	\$677,000

(1) Preferred stock was reclassified from equity to liabilities in 2003 with the adoption of SFAS No. 150. Accordingly, preferred stock dividend requirements were reclassified to interest expense effective July 1, 2003. See Note 2 of the Consolidated Financial Statements. Balance as of December 31, 2004 and 2003 does not include current portion.

(2) Preferred trust securities was reclassified to Long-term debt to affiliated trusts in 2003 with the adoption of FASB Interpretation No. 46 and the deconsolidation of the capital trusts that have issued the preferred trust securities. See Note 2 of the Consolidated Financial Statements.

SELECTED FINANCIAL DATA

	2004	2003	2002	2001	2000	1994
ISTA UTILITIES						
Electric Operations						
Electric operating revenues (millions of dollars):						
Residential	\$209.5	\$204.8	\$196.1	\$158.8	\$158.1	\$146.9
Commercial	201.8	201.3	194.7	155.4	149.8	131.3
Industrial	90.3	78.3	68.1	80.4	83.0	57.4
Public street and highway lighting	4.8	4.8	4.7	3.8	3.6	3.1
Total retail revenues	506.4	489.2	463.6	398.4	394.5	338.7
Wholesale revenues	62.4	73.4	64.1	480.9	864.7	91.4
Revenues from sales of fuel	64.0	71.5	40.9	19.0	1.3	-
Other revenues	19.3	16.8	15.5	23.9	26.8	21.2
Total electric operating revenues	\$652.1	\$650.9	\$584.1	\$922.2	\$1,287.3	\$451.3
Electric energy sales (millions of kWhs):						
Residential	3,343.1	3,297.9	3,202.9	3,219.4	3,279.4	3,035.2
Commercial	2,918.6	2,919.4	2,836.7	2,882.0	2,885.8	2,476.8
Industrial	2,076.1	1,785.1	1,519.1	1,891.2	2,047.9	1,705.3
Public street and highway lighting	25.3	25.3	25.2	25.0	24.7	22.3
Total retail energy sales	8,363.1	8,027.7	7,583.9	8,017.6	8,237.8	7,239.6
Wholesale energy sales	1,471.6	2,075.2	2,215.5	6,261.6	15,806.7	2,886.9
Total electric energy sales	9,834.7	10,102.9	9,799.4	14,279.2	24,044.5	10,126.5
Electric customers (average per year):						
Residential	288,422	283,497	279,735	276,845	273,219	239,733
Commercial	36,728	36,279	35,910	35,454	35,060	29,402
Industrial	1,416	1,414	1,420	1,434	1,254	999
Public street and highway lighting	418	422	413	402	392	325
Total electric retail customers	326,984	321,612	317,478	314,135	309,925	270,459
Wholesale	43	47	46	44	58	27
Total electric customers	327,027	321,659	317,524	314,179	309,983	270,486
Electric customers (at year-end):						
Residential	292,150	287,141	282,269	279,129	276,382	243,511
Commercial	37,040	36,551	36,106	35,726	35,109	29,984
Industrial	1,416	1,426	1,409	1,424	1,398	942
Public street and highway lighting	408	436	426	415	401	328
Total retail electric customers	331,014	325,554	320,210	316,694	313,290	274,765
Wholesale	45	38	50	32	51	29
Total electric customers	331,059	325,592	320,260	316,726	313,341	274,794
Revenue per residential kWh (cents)	6.27	6.21	6.12	4.93	4.82	4.84
Use per residential customer (kWh)	11,591	11,633	11,450	11,629	12,003	12,661
Revenue per commercial kWh (cents)	6.91	6.90	6.86	5.39	5.19	5.30
Use per commercial customer (kWh)	79,465	80,472	78,995	81,288	82,311	84,238
Electric energy resources (millions of kWhs):						
Hydro generation (from Company facilities)	3,789.0	3,539.6	4,009.6	2,563.8	3,818.7	2,904.5
Thermal generation (from Company facilities)	2,408.3	2,398.0	1,714.3	3,000.7	3,153.6	3,426.6
Purchased power - long-term hydro contracts	794.0	774.6	836.6	631.4	928.6	1,177.0
Purchased power - wholesale	3,421.8	3,909.4	3,827.8	8,623.7	16,705.8	3,145.6
Power exchanges	37.6	36.1	13.4	(103.7)	67.2	(24.1)
Total power resources	10,450.7	10,657.7	10,401.7	14,715.9	24,673.9	10,629.6
Energy losses and company use	(616.0)	(554.8)	(602.3)	(436.7)	(629.4)	(503.1)
Total electric energy resources	9,834.7	10,102.9	9,799.4	14,279.2	24,044.5	10,126.5

SELECTED FINANCIAL DATA

	2004	2003	2002	2001	2000	1994
Electric Operations (continued)						
Total resources available at peak (MW):						
Company owned:						
Hydro	965	955	955	956	956	970
Thermal	532	695	426	462	586	531
Purchased power:						
Long-term hydro contracts	167	174	159	144	184	230
Other	888	733	673	1,991	2,468	737
Total resources available at peak (winter)	2,552	2,557	2,213	3,553	4,194	2,468
Net system peak demand (winter)	1,766	1,509	1,346	1,500	1,491	1,452
Wholesale obligations	454	417	297	1,734	2,338	781
Total requirements (winter)	2,220	1,926	1,643	3,234	3,829	2,233
Reserve margin	13%	25%	26%	9%	9%	11%
Annual load factor	62%	65%	62%	65%	68%	61%
Average cost of production (cents per kWh)	2.78	2.76	2.30	3.41	2.70	2.70
Natural Gas Operations						
Natural gas operating revenues (millions of dollars):						
Residential	\$194.5	\$166.9	\$184.0	\$179.6	\$128.2	\$76.6
Commercial	104.7	90.5	105.0	104.0	70.0	51.0
Industrial	9.4	7.5	7.1	11.2	7.7	9.2
Total retail revenues	308.6	264.9	296.1	294.8	205.9	136.8
Wholesale revenues	0.2	0.3	0.7	1.8	5.7	5.1
Transportation revenues	3.1	8.5	9.6	8.6	10.2	11.1
Other revenues	3.6	3.6	3.4	3.4	3.0	3.8
Total natural gas operating revenues	\$320.5	\$277.3	\$309.8	\$308.6	\$224.8	\$156.8
Natural therms delivered (millions of therms):						
Residential	201.7	198.5	199.7	198.4	212.2	150.1
Commercial	122.8	122.1	126.2	126.9	135.1	120.9
Industrial	13.3	12.7	11.3	15.5	18.3	28.4
Total retail	337.8	333.3	337.2	340.8	365.6	299.4
Transportation and other	157.8	157.2	179.3	201.2	230.3	231.9
Total natural gas therms delivered	495.6	490.5	516.5	542.0	595.9	531.3
Natural gas customers (average per year):						
Residential	268,571	261,063	254,700	249,650	242,983	179,176
Commercial	31,886	31,312	30,823	30,355	29,739	23,466
Industrial	311	310	315	328	334	297
Total retail customers	300,768	292,685	285,838	280,333	273,056	202,939
Transportation and other	82	85	89	88	98	61
Total natural gas customers	300,850	292,770	285,927	280,421	273,154	203,000
Natural gas customers (at year-end):						
Residential	272,871	266,252	258,738	253,325	248,418	187,679
Commercial	31,675	31,732	31,141	30,697	30,138	24,115
Industrial	304	312	309	318	332	293
Total retail customers	304,850	298,296	290,188	284,340	278,888	212,087
Transportation and other	82	76	90	82	96	98
Total natural gas customers	304,932	298,372	290,278	284,422	278,984	212,185

SELECTED FINANCIAL DATA

	2004	2003	2002	2001	2000	1994
Natural Gas Operations (continued)						
Revenue per residential therm (cents)	96.42	84.11	92.13	90.51	60.43	51.03
Use per residential customer (therms)	751	760	784	795	873	838
Revenue per commercial therm (cents)	85.27	74.13	83.17	81.98	51.79	42.17
Use per commercial customer (therms)	3,853	3,900	4,095	4,180	4,544	5,152
Heating degree days (at Spokane, Washington):						
Actual	6,314	6,351	6,818	6,800	7,176	6,225
30 year average	6,820	6,820	6,842	6,842	6,842	6,842
Actual as a percent of average	93%	93%	100%	99%	105%	91%
ENERGY MARKETING AND RESOURCE MANAGEMENT						
Operating revenues (millions of dollars)	\$275.6	\$307.1	\$222.6	\$403.8	\$546.9	\$ -
Resource costs (millions of dollars)	236.8	246.9	168.4	269.5	239.2	-
Gross margin (millions of dollars)	\$38.8	\$60.2	\$54.2	\$134.3	\$307.7	\$ -
Gross Physical Realized Sales Volume						
Electricity (thousands of MWhs)	32,629	41,579	40,426	47,927	105,548	-
Natural gas (thousands of dekatherms)	219,719	228,397	225,983	248,193	273,448	-
Coal (thousands of tons)	-	-	-	-	3,514	-
Total assets (millions of dollars)	\$1,002.8	\$1,013.2	\$1,349.6	\$1,506.2	\$10,271.8	\$ -
VISTA ADVANTAGE						
Revenues (millions of dollars)	\$23.4	\$19.8	\$16.9	\$13.2	\$5.0	\$ -
Total assets (millions of dollars)	\$47.3	\$45.6	\$31.7	\$20.3	\$11.1	\$ -
WYOMING POWER						
Revenues (millions of dollars)	\$17.1	\$13.6	\$14.6	\$16.4	\$32.9	\$62.7
Total assets (millions of dollars)	\$53.3	\$48.3	\$42.9	\$86.5	\$96.4	\$173.6